Tax Laws and Tax Planning

THEORY AND PRACTICE

Jit Bahadur K.C.

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Dedicated to my late father

Purna Bahadur Khadka

who passed away at an early age

and

my mother **Mrs. Bhima** *raised me,*

gave me her unselfish love

and

taught me how to love and be loved.

PREFACE TO THE SECOND EDITION

Tax laws change every year. Since the publication of the first edition of Tax Laws and Tax Planning: Theory and Practice, some tax laws have been changed. These changes represent modifications in tax law.

The second edition has two folds requisitions: to provide and present up-to-date information on the Nepal income tax system and to add some new enhancements materials.

Thus, this present edition has revised throughout and some chapters either materially added to or re-cast.

May 10, 2007 Author
Mahadevtar, Kathmandu.

PREFACE TO THE FIRST EDITION

Taxation plays a vital role in state economy. Therefore, writers like Jean Baptiste Colbert as well as Adam Smith have spoken very persuasively on the significance of the taxation. The main philosophy behind taxation is that every individual should contribute towards the expense of the government. Adam Smith, the father of economics, mentions that "the subjects of every state ought to contribute towards the support of the government". Similarly, Jean Baptiste Colbert advices - "The art of taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing". However, least possible squealing too affects all people who hate to pay taxes but benefit from the revenues generated. The need for and the benefits of the state revenues are growing rapidly. Thus, taxation is becoming more and more a crucial issue.

The Income Tax Act 2002 of Nepal is marvelously complex. It contains many issues, principles and doctrines. There is no denying that the Act contains long sentences and many sentences do rely upon cross-references for complete understanding. It requires reading for more than once to get real meaning. In many provisions, there are exceptions to rules and also exceptions to the exceptions. Thus, it is only possible to understand the Act using an appropriate book that gives explanatory details.

The practical knowledge on tax and its proper planning is an essence for effective functioning. Considering this fact, efforts have been made to impart such knowledge and skills to better accrue maximum benefits by providing good academic education to fulfill nation's demand.

Available academic books and literatures on taxation targeted to the Post-Graduate level students of management faculty have focused more on theoretical aspects. Thus, this book attempts to benefit the students by emphasizing on illustrative examples relevant in Nepalese context. Apart from Post-Graduate level students of Tribhuvan University, this book is also useful to students of other Universities and Colleges. It is equally important to Chartered Accountants, Auditors, Lawyers, Business Persons, Managers and Investors.

It includes calculation of tax liability of both individual and entity. It explicitly explains inclusions and exclusions from business and investment income; deductions allowed in calculation of taxable income; basic timing and accounting issues; and characterization of income. This book explains proper taxpayer responsible for reporting, methods of taxation of income, and need of compliance.

Everyone knows tax is a funny subject. Sometimes it requires funny cases to make readers understand the subject matter. This book has several instructional goals. It intends to improve reader's ability to comprehend and apply complex statutes and regulations. If any reader forgets the rules, s/he may quickly recall through cases. Many aspects of this book emphasize to improve analytical skills. For example, there are several examples including cases, tables, flowcharts and review questions and cases throughout the book. Review questions and cases are designed to measure immediate comprehension of core topics and to apply the provisions for self-assessment of readers. In addition, each major chapter of the book contains cases designed for class discussion. The cases are generally more complicated than the review questions and cases.

Hence, I believe this book facilitates to learn the fundamental concepts related to income taxation and its tax planning more easily than through existing resources.

Finally, I would like to express my sincere gratitude to Bhagirath Kafle who inspired me to write this book. I would also like to express my sincere thanks to Rabin Bastola who rid grammatical errors and to those who took responsibility to publish and distribute the book.

August 17, 2006 Author

LIST OF ABBREVIATIONS

§	Abbreviation for Section/s
A.D.	Anno Domini (after the birth of Jesus Christ)
ALP	Arms Length Principles
A.M./a.m.	Ante Meridiem (in the Period Between Midnight and Noon)
ARF	Approved Retirement Fund
BOT	Build Operate and Transfer
BPRTA	Business Profits and Remuneration Tax Act
BS	Bikram Sambat
C.A.	Chartered Accountants
CAP	Commercial Accounting Principles
CGT	Capital Gain Tax
CENVAT	Central Value Added Tax
CIT	Citizen Investment Trust
CRF	Contribution to Retirement Fund
DDC	District Development Committee
DFL	Degree of Financial Leverage
DG	The Director General
DOL	Degree of Operating Leverage
DTAA	Double Taxation Avoidance Agreement
EAT	Earning After Tax
EBIT	Earning Before Interest and Taxes
EBT	Earning Before Tax
EPF	Employee Provident Fund
EU	the European Union
FARS	Financial Accounting and Reporting Standard
FIFO	First-In-First-Out
FITTA	Foreign Investment and Technology Transfer Act
GAAP	General Accepted Accounting Principles
GAAR	General Anti-Avoidance Rule
GB	the Great Britain
GM	General Manager
GNP	Gross National Product
GoN	the Government of Nepal
http	hypertext transfer protocol
ICAN	the Institute of Chartered Accountants of Nepal
IMF	International Monetary Fund
INGO	International Non-Governmental Organization
IRD	Inland Revenue Department

IRO	Inland Revenue Office
ITA	Income Tax Act
ITR	Income Tax Rules
LDT	Lumbini Development Trust
LIFO	Last-In-First-Out
Ltd.	Limited
MODVAT	Modified Value Added Tax
n.d.	Not availed of published date
NGO	Non-Governmental Organization
NITA	Nepal Income Tax Act
NRB	Nepal Rastra Bank
NSE	Nepal Stock Exchange
OECD	Organization for Economic Cooperation & Development
PAN	Permanent Accounts Number
PAYE	Pay-Tax-As-You-Earn
PDT	Pashupati Development Trust
PC	Pollution Control
PFA	Partnership Firm Act
PTA	Property Tax Act
Pvt. Ltd.	Private Limited
R&D	Research and Development
R&I	Repair and improvement
ROE	Return on Equity
S/he	She or he
Sc	Schedule
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Programs
US	United States
USAID	United States Agency for International Development
VAT	Value Added Tax
VDC	Village Development Committee
w/n	Working Notes
www	World Wide Web
Year(s)	Year (Years)

CONTENTS

PART

1

Introduction of Taxation

Chapter 1

Conceptual Foundation

1.1 CONCEPT AND MEANING

A government specially gets revenue from taxes, fees, price and other sources: grants and gifts. In case of State Revenue, a tax is a compulsory charge imposed by government without any reference to service rendered to taxpayers. Fines or penalties imposed by courts resemble taxes since there is compulsion in both. The distinction between them, however, is one of the motives. Generally, taxes are imposed to obtain revenue while fines are imposed as a punishment to control mistakes in future. The State sells some of its goods or services and receives price in payment for them. The distinction between taxes and price is that, tax is a compulsory payment to be made by every citizen as levied by the government whereas price is to be paid by persons who buy services or goods produced by the government. Thus, tax is an ingredient of State Revenue in public finance.

In this modern age, a government needs many revenues in order to influence the macroeconomic performance of economy or fiscal policy,

to carry out functions of the government: national defense and to redistribute resources among individuals or classes in the population. In this context, tax is a significant and inseparable source of State Revenue of the government. According to its nature, it is the most reliable, certain, flexible, and convenient source to obtain the required amount. Therefore, the government of any country upholds main priority in tax revenue.

1.1.1 Meaning of Taxation

Taxation is a system of levying taxes. The system is a set of principles. The principle is a scheme of ideas or body of rules by which a theory is organized. Thus, the system of levies was developed after the origin of tax. About the origin of tax, Ayto (2004) points out that:

> Tax originally denoted to assess an amount to be levied; the notion of imposing such a levy is a secondary development. The word comes passing through old French '*taxer*' from Latin '*taxare*' a derivative of '*tangere*' of English. The *taxare* was derived from Medieval Latin noun '*taxa*', *which* means an allotted piece of work or task, which passed into English through Anglo-Norman '*tasque*' as task (pp. 521-522).

Many economists have stated concept of taxation and all they agree that taxation is the system whereby taxes are levied on some types of income, earnings, or gains or purchases. In this connection, the Columbia Encyclopedia (2006) cites one of the most absolute and extensive definition as:

> Taxation is a system used by governments to obtain money from people and organizations. The government uses collected revenue to support itself and to provide public services. In its nature, it is relatively permanent and compulsory and does not guarantee a direct relationship between the amount contributed by a citizen and the extent of governmental services provided to him (2006).

Therefore, taxation is a device or process of imposing a tax.

Similarly, one of the famous economists delineates that "Taxation is the charge levied by the State on the property or labor of the citizens, in order to provide for the public expenses" (De Parieu). However, it is quite different from former definition of the Columbia Encyclopedia. It is alike a definition of tax though it shares some qualities, but not identical.

Tax and taxation are not synonymous terms. Tax is a compulsory exaction of money by public authority for public purposes enforceable by law and is not a payment for service rendered while taxation is device for

imposing a tax. Thus, tax is a charge by the government on income, property, or expenses of an individual or group of individuals and taxation is a device or process of taxing or imposing tax.

1.1.2 Meaning of Tax

Various economists have defined concept of tax in their own ways. Some of them have created confusion in conception. For the far from top to bottom study, a number of definitions are substantial narrow while some are vague and wordiness. Thus, some valued definitions given by some well-known scholars have acknowledged below.

Among various distinguished scholars, tax definition of Bastable comes into view substantial clear. The term is defined as, "A tax is a compulsory contribution of wealth of a person or body of persons for the service of public power" (Bastable, 1917).

The stipulated definition includes each significant terms and helps to make clear the object defined. The mentioned terms clarify and hold the following meaning:

☐ Compulsory

As stated by Bastable, tax is compulsory. The term compulsory denotes 'required by law or an authority'. However, this does not mean that all the tax revenues are paid reluctantly, but simply that the will of the payer is legally immaterial. Usually, the amount, the mode and time of levying; factors affect the persons, are all determined by the ruler and individual preferences are allowed no place. Therefore, tax is compulsory.

☐ Contribution

Tax is a 'contribution' that involves a sacrifice on the part of contributor. It is also possible that some people may gain through the operation of a tax of which they themselves pay a part. But, it is rather an operation of tax than its payment by the people affected who produces this result. Every tax necessitates a deduction from wealth of the contributor, even though compensation may be indirectly brought about through its action. Thus, tax is a contribution by the payer to the nation.

☐ Wealth

In this definition, the term 'wealth' has used in an extensive sense. It includes wealth for 'services' as well as 'commodities'. For example, if a military labor force used for repairing roads, tunnel, bridge etc., it is fairly taxation as a payment of money or goods. These may be different from taxation. But, they must be considered in the category of taxes. Thus, tax is a contribution of wealth.

☐ Person

Bastable justifies all taxes are imposed on 'persons'. Circumstances, which are formed by the State law, are duty of a person. Thus, payment of taxation is a duty, and persons only can be liable to duties. Taxes may be classified into two categories: 'personal' and 'real'. These are different uses of taxation. The term 'real' refers to the 'object' of taxation; ultimate bearer is the 'subject' of tax, and he should be a person. Therefore, it is true that someone must pay tax ultimately.

☐ Service or Benefit

All taxes are levied for 'service' or 'benefit'. The public economy requires supply of its wants, and taxation is the mode of meeting whatever proportion of those wants remains unsatisfied from other parts of public revenue.

☐ Public Power

Taxation is for the 'public powers.' It has to meet the wants of both central and local governments of the State. Bastable further argues:

> All contributions to the various organs of government are taxes in the view of finance, whatever is their administrative name. Special kinds of taxation have often denounced as being for the benefit of classes or individuals, not for that of the State.

Thus, taxation creates public power through revenue.

The instructed definitions with additional explanations convey all that is essential to get an idea of taxation.

In simple, "Tax is a compulsory payment by the people to the nation. If a person defies the payment of tax, he is punished by court of law," (Lekhi, 2002, p. 162).

Likewise, other writers on the subject have given definitions, which significantly agree with crucial elements of tax. Campbell, Nolan, and Jacqueline (1990) state:

> In a general sense, any contribution imposed by government upon individuals, for the use and service of the state, whether under the name of toll, tribute, impost, duty, custom, excise, subsidy, aid, supply, or other name. And in its essential characteristics is not a debt (p. 1457).

As well Roscher (as cited in Bastable, 1917) states:

> Taxes are the contributions, which individual economies must pay, in consequence of their dependence, to the State, province, commune, etc., or, generally, the particular collective compulsory economy placed over them in order to assist in satisfying the financial needs of the receivers.

Similarly, "The tax is the share of income of citizens, which the State appropriates in order to procure for itself the means necessary for the production of general public service" (De Marco). "The essence of a tax is distinguished from other charges by government in the absence of a direct quid pro quo between the tax-payer and public authority" (Taussig). "A tax is an involuntary fee paid by individuals or businesses to a State or to functional equivalents of a State, including tribes, secessionist movements or revolutionary movements" (Wikipedia, 2006).

The above-mentioned definitions convey that taxes are not voluntary contributions but are compulsory. Therefore, tax is a compulsory charge by governments on income of an individual, corporation, or trust, as well as the value of gift. The government does not provide direct return in benefit of taxpayer but it is incurred for the common interest of people. "Taxes are what we pay for civilized society" (Holmes as cited in Kenneth, 2005; p. 72). Thus, the foremost and essential characteristics of tax are that it is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority.

1.2 PRINCIPLES OF TAXATION

The principal purpose of taxation is to raise required revenue to support public services. Good tax system is a prerequisite to attain goal of required revenue. The goal may obtain through many ways. But, there are setup principles written by various scholars. The principles of good taxation emerged since the start of the seventeenth century. A French scholar, Jean Baptiste Colbert (as cited in Norton, 2001) argues that a fundamental deliberation about principles of taxation. In his argument, "The art of taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing" (Colbert). Likewise, the famous economist, Adam Smith wrote, 'An Inquiry into the Nature and Causes of the Wealth of Nations' in 1776 and mentioned four maxims of taxation. However, among the tax systems of different nations, wide variations exist in how money is raised and spent. Tax and expenditure policies reveal the fundamental ideology of a government and a political system.

The successive writers to the development of taxation principles may be distinctly divided into two approaches: (1) "the benefit approach" and (2) "the ability to pay approach" Musgrave (as cited in Choudhry, 2002). He argues that benefit approach views the tax services supplied by government free of direct charges. In ability-to-pay approach, taxation that is unrelated to benefit is seen as a compulsory payment and the revenue expenditure process is viewed as a planning problem not subject

to solution by the rules of market. Thus, the principles to design a good tax system are evaluated on the basis ability-to-pay principles. This approach views as of equity and fairness, simplicity, neutrality, efficiency, incentives, and indexation.

1.2.1 Equity and Fairness

Colton (n.d.) describes in a quotation about law and equity, "Law and equity are two things which God hath joined, but which man hath put asunder". However, in taxation equity cannot be uninformed.

Equity and fairness denote a general condition characterized by justice and impartiality in the tax system. The condition of justice and impartiality is a very crucial aspect of tax policy to intersect each other. Economists consider four principles of equity and fairness to determine the burden of a tax such as horizontal equity, vertical equity, progressivity, and perceived fairness.

☐ Horizontal Equity

Horizontal equity states that people in equal positions should pay the same amount of tax. If two people have same amount of income then horizontal equity requires that they pay the same amount of tax. It is measured through the same situation faced by an individual such as same age, same number of dependents, same volume of income, same place and same type of income etc. It assumes that if individuals are of same condition, they should have the same tax liabilities.

> **EXAMPLE 1-1** Black's income for the year consists solely Rs. 40,000 in royalty. White's income consists solely Rs. 40,000 in royalty. Both pay a tax at the rate of 15 percent, or Rs. 6,000 in taxes. There is horizontal equity.
>
> **EXAMPLE 1-2** Tad has taxable income from sale of devices Rs. 60,000. Pole has taxable income Rs. 60,000 from sale of appliances. Both pay tax Rs. 15,000. It is horizontal equity.

The above stated examples convey that similarly situated taxpayer should face a similar tax treatment or tax burden. Thus, horizontal equity regards that people in the same income group should be taxed at the same rate or equals should be taxed equally.

☐ Vertical Equity

It is analyzed to find the effects of tax from bottom to top according to its range. It can be measured based on tax structure such as regressive tax, flat tax and progressive tax. In 2003, Lawrence describes that individuals with greater "ability to pay" should bear proportionally a higher tax burden such as a "progressive" income tax (redistribution).

EXAMPLE 1-3 Assume **EXAMPLE 1-1**, in addition to the Rs. 40,000 of income, Black has an additional Rs. 45,000 of royalty income, giving him a total of Rs. 85,000 in income. If he is still taxed at the rate of 15 percent, there is no vertical equity; if he is taxed, a higher rate there may be vertical equity, since Black pays proportionately more taxes than White does.

Thus, vertical equity concept concerns that people in different income groups should pay different rates of taxes or different percentages of their incomes as taxes or unequal should be taxed unequally.

☐ **Progressivity**

The term progrssivity refers the degree to which a tax imposes a proportionately heavier burden on high-income people than on low-income people. In Nepal, house and land tax is, generally regarded as progressive tax. Progressivity may measure based on diminishing marginal utility of income. The loss of utility of one additional rupee of tax is higher for a low-income individual than a high-income individual. Thus, it justifies that flat tax is not fair.

☐ **Perceived Fairness**

"Perceived fairness is just as important as substantive fairness as it encourages voluntary compliance and hence reduces administrative costs. Perceived unfairness breeds contempt in the tax system and encourages tax evasion" (Lawrence, 2003). Thus, the perceived fairness is an inseparable module of principles of taxation.

1.2.2 Simplicity

Simplicity is an important aspect of taxation. Complicated tax principles make the tax system difficult for citizens to understand. Complexity is harmful for both government and taxpayers. Therefore, principles of taxation require the following qualities.

- A simple tax is easy to understand and it encourages compliance.
- A simple tax implies low transactions costs for both taxpayers and government.
- A simple tax is also easy to put into practice.

Simplicity in the tax system is important both to taxpayers and to those who administer the various taxes. Complex rules lead to errors and disrespect for the system that can reduce compliance. Thus, simple principles of taxation help to eliminate tax loopholes and encourage compliance. Moreover, the tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

1.2.3 Neutrality

Principles of taxation should be neutral for both individual and corporate income. Wikipedia (2006) mentions:

> Fiscal neutrality is a term referring to the impact of taxation on the economy. When it is said that fiscal neutrality is desirable, the meaning is that the tax measure or policy should not introduce excess burden into the normal working of the economy by significantly distorting economic incentives and changing behavior.
>
> **EXAMPLE 1-4** A sales tax applied to all goods will tend to discourage consumption of all the taxed items, and an income tax will tend to discourage people from earning money in the category of income that is taxed. Some people may move out of the work force; some may move into the cash or black economies.

Thus, principles of taxation should avoid a distinctive quality for one. The distinctive quality for one encourages to shift investment from one to another for future benefit ignoring real spending economic decision.

1.2.4 Efficiency

A good tax system should spend as little amount and resources as possible to obtain a huge amount of revenue. Taxes those are costly or difficult to administer redirect resources to non-productive uses and reduce assurance in both the levy and the government. Worse still, waste can also be created by excessive tax rates; economic efforts are then shunted from high-into low-yielding activities, from productive enterprises into tax shelters, and from open, above-board transactions into hidden, off-the-record participation in the underground economy. Therefore, there are three basic factors come into consideration: administration costs, compliance costs and excess burden to judge the quality of efficiency.

☐ Administration Costs

Government needs costs for revenue administration. Revenue administration is the constituent of various tax collectors to gather the revenue, data entry clerks to process tax returns, auditors to inspect the return, lawyers to handle disputes and accountants to track the flow of amounts. Thus, government should strive to minimize the costs of administration.

☐ Compliance Costs

Taxpayer also needs costs for tax compliance for his tax return. These costs include the amount spent on accountants, tax lawyers, and tax

preparers, as well as the value of taxpayers' time spent filling out tax returns and keeping records.

☐ Excess Burden

A third measure of a tax system's efficiency takes into account the fact that when the government levies a tax on goods the consumer deny it and changes his behavior of buying. This type of behavior reduces tax revenue to government. In taxation philosophy, this behavior is called an excess burden. It upgrades excess burden of a tax.

1.2.5 Incentives

Tax incentives are items of motivations towards taxation. In absence of the motivation and if tax rates that are too progressive- that rise too steeply- may discourage both work and investment by removing much of the reward. In 2003, Lawrence presents some basic norms of incentives for the principles of taxation as:

- Both a zero-rated and an hundred percent rated taxation result zero tax revenue.
- Based on worldwide experience; the maximum marginal tax rate on personal income taxation should not be much higher than 35 percent. If else, the incentive to work and save, and the incentive for faithful voluntary compliance, will be reduced as the incentive to evade taxes is enhanced.
- The marginal personal income tax rates should be constant for a relatively broad range of taxable income. The brackets should be reasonably "long" for the taxable income.
- One should always focus on the net tax revenue that can be collected taking into account the costs of collection and enforcement and incentive effects.

1.2.6 Indexation

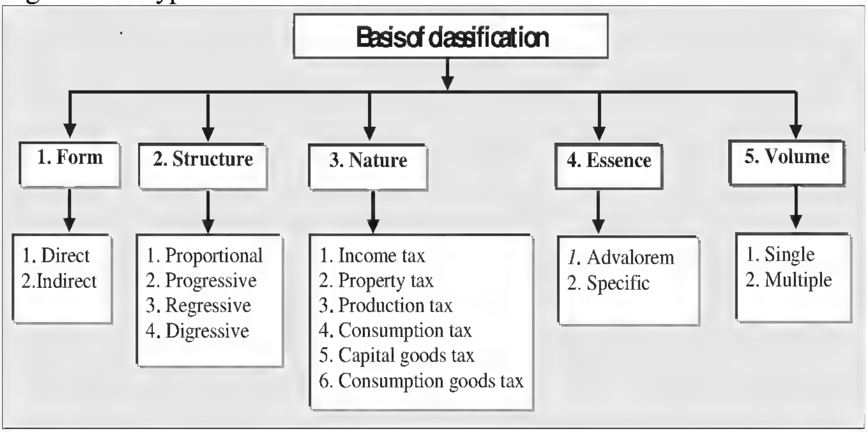
Principles of taxation should include indexation of tax bracket amounts to the national rate of inflation to reflect the real burden. It helps to revise tax law appropriately from time to time.

The outlined principles of taxation can come into conflict with each other however each of these principles certainly help policymaker to improve State's tax system. James Otis argues "taxation without representation is tyranny." Thus, a good taxation principle also requires compliance to make principles from representation.

1.3 TYPES AND CLASSIFICATION OF TAXES

Taxes are constituents of human life and are paid from birth to death. Now a days, a human activity can not separate from taxes. It means there are many taxes and these are paid knowingly or unknowingly and directly or indirectly. Moreover, these are impossible to signify individually. Thus, economists have classified a long list of different types of taxes into five classes. These may be grouped on the basis of their form, structure, nature, essence and volume.

Figure 1.1: Types and Classification of taxes



1.3.1 Classification on the Basis of Form

Based on form, economists have divided taxes into two categories: direct and indirect. Specially, these taxes are based on place of payment.

☐ Direct and Indirect Taxes

One of the most important and widely used classifications of taxes is the direct and indirect tax. The economists who are devoted on the principles of taxation have defined it in their own way.

In 1917 (the first was on 1892), Bastable wrote 'Public Finance' and stated that, "Those taxes are direct which are levied on permanent and recurring occasions, while charges on occasional and particular events are placed under the category of indirect taxation" (Bastable).

Bastable's distinction between direct and indirect taxes is vague. The above stated definition makes confusion too. Both direct and indirect taxes may be of recurring nature but direct taxes are more permanent in nature as compared to indirect. Thus, Bastable's definition could not clarify the position of direct and indirect taxes.

In 1903, Mill defined direct and indirect taxes as:

> A direct tax is one, which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those, which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another.

The stated definition clears that a direct tax is actually paid by the person on whom it is imposed formally; while an indirect tax is imposed on one person but another person abide to pay it partly or wholly. Therefore, income tax, interest tax, gift tax, property tax, death tax, vehicle tax etc. are direct taxes; and sales tax, value added tax; entertainment tax, hotel tax etc. are indirect taxes. Until now, the stated classification of Mill is quite practical and convenient.

Brainy Encyclopedia (2006) describes, in the United States the term direct and indirect taxes have more than one meaning: a colloquial meaning and a constitutional law meaning. Certain taxes may be direct taxes in the colloquial sense but indirect taxes in the constitutional sense.

Brainy Encyclopedia (2006) summarizes:

> In the colloquial sense, a direct tax is one paid directly to the government by the persons (legal or natural) on whom it is imposed (a tax return filed by the taxpayer). Since the stated meaning income taxes, corporate taxes and transfer taxes—inheritance tax and gift tax—are the examples of direct taxes. In this sense, a direct tax is contrasted with an indirect tax (it may be called a 'collected' tax too). In this sense sales tax or value added tax are the example of indirect or collected tax. A collected tax is one, which is collected by intermediaries who turn over the proceeds to the government and file the related tax return.
>
> In a constitutional law sense, the term direct tax has a different meaning. Traditionally a direct tax denotes a tax on property because of its ownership as well as a capitation of a head tax. Similarly, an indirect tax or excise is an event tax. In this sense, a transfer taxes—inheritance and gift tax—are indirect taxes. Moreover, income taxes on income from personal services such as wages are also indirect taxes.

Lekhi (2004) considered controversy assertions of concept of direct and indirect tax by the various economists, thus, he unambiguously clears that is not easy to distinguish between direct taxes and indirect taxes. A tax may be direct or indirect depending on situation.

A. Merits of Direct Taxes

Direct taxes contain the following merits.

1. Equitable: Direct taxes follow the principle of equity. The equity is based on ability-to-pay where the burden of tax is distributed among different citizens proportionately. This principle also proves that economic redistribution in society.

2. Certainty: Direct taxes involve the principles of certainty in terms of time, place and amount. Therefore, it helps to regulate time limit, to modify income or expenses and to adjust flow of money. It also facilitates to control corruption in revenue administration providing accurate and adequate information.

3. Economy: Direct taxes are economy. Most of the income taxes, property taxes, vehicle taxes etc. are of progressive nature. Thus, their costs of collection do not necessarily increase with the increase in tax yield. In addition, such taxes are collected in short span of time. Thus, direct taxes are economy.

4. Elastic: Direct taxes are based on principle of elasticity. Direct taxes are assessed at/after the end of year. Therefore, a government can inflate its rate during the year at any time to get more tax revenue if there is flexible tax policy. Simply, volume of tax depends on the rate of tax and volume of citizen's wealth. Thus, the direct tax may be extended in rate during the year and it recognizes the elastic of taxation. This principle favors to the government. In reality, the government has to bear continuous pressure due to expanding needs and face problems of revenue collection. Therefore, principle of elasticity is significantly important to launch necessary programs and overcome crisis due to unexpected incidents.

5. Civic consciousness: Direct taxes create civic consciousness. In case of direct taxes, taxpayers directly feel burden of taxes and accordingly take keen interest on public expenditures. In addition, taxpayers watch their rights and responsibilities as citizens of the State. Thus, direct taxes are not only revenue raiser but also are to know how public authority spends the collected revenue.

6. Remedy of adverse effect: Harmful effects of direct taxes can easily notice and the public authority can easily correct them by introducing appropriate corrective measure.

EXAMPLE 1-5 If high rates of income taxes adversely affect the capacity of earning, willingness of work and saving interest of the society; it results into decrease in the rate of productivity which can

easily notice. Thus, the public authority may introduce corrective measures of tax concession immediately in order to defy this ill situation.

7. Easy to understand: Direct taxes are easily understandable even by the common people. Thus, it is easy to introduce at minimum cost.

B. Demerits of Direct Taxes

It is an artificial fact to assume that something possess only merits. However, direct taxes are superior to indirect taxes they also possess following demerits.

1. Arbitrary: Direct taxes are considered as willful or intentional. Under this tax rich people pays more tax. On the other hand, rate of direct taxes depends on the political structure of the government. Generally, the democratic governments levy low rate of taxes while the leftist government levy stiff and rigid rate of taxes. Thus, in direct tax the quality of justice is flexible and it reflects willful and arbitrary features.

2. Expensive: Direct taxes are often observed as expensive due to the method employed to collect them. The cost of collection may be quite high when the number of taxpayers is numerous and the amount of tax collected is of small quantity. In such case, it requires more staff and infrastructures in comparison to the amount collected thereby increasing the cost of tax collection. Thus, the collected amount of revenue may be less than the administrative cost.

3. Large scale evasion: When tax rates are highly progressive, the tendency of tax evasion is always possible in case of direct taxes. In addition, when a taxpayer has to pay a huge amount at a time at the end of a year, the taxpayer tends to submit a false statement of his income and wealth. Thus, the probability of tax evasion is higher in direct taxes. Stringent and costly systems of fine and penalty are adopted to avoid evasion; however, these tightened principles may not eliminate all cases of tax evasion.

4. Few number of taxpayers: In particular, only the well off pays directs tax. In direct tax, there is no any role of have not. Thus, number of taxpayer in direct taxes becomes fewer.

5. Tax on honest persons: Many States in modern world have adopted the principles of self-assessment system. In case of progressive taxation, the tax burden may be very low if a false statement is submitted. The submission of false statement is widely

practiced and it may not be possible to detect it by tax administration. Thus, direct tax system creates injustice in economic redistribution and it is levied and paid by few honest persons.

6. Not suitable in underdeveloped economies: Direct taxes are considered harmful to under-developed economies. It reduces the saving of common people and increases unemployment. Thus, direct taxes are not treated as good tax for under-developed economy. In addition, illiterate citizens may not grasp spirit of direct taxes.

A. Merits of Indirect Taxes

Indirect taxes have the following merits.

1. Convenience: Indirect taxes satisfy the principle of convenience. These are paid in small installments instead of lump sum by the user of service or goods. They are imposed at the time of purchase of a commodity or the enjoyment of a service so that the taxpayers do not feel the burden of tax. Besides, the burden of indirect taxes is not completely felt, since the tax amount is actually hidden in the price of the commodity bought. Thus, indirect taxes are convenient to collect.

2. Mass participation of taxpayers: Mass participation involves indirect taxes through mass transactions made by people. In other words, the indirect taxes can be imposed on goods and services that are used in day-to-day life.

3. Means of reaching the poor: The defender of indirect taxes also argues that these taxes are means of reaching the poor. An indirect tax may be a small contribution when the commodity is purchased in small quantity or number. It does not discriminate any poor and rich to contribute something towards the maintenance of the State. Thus, indirect taxes are chief means to reach poor by bringing all citizens into a tax net.

4. Difficult to evade: Indirect taxes are generally included in the price of commodities, therefore, the payment of such taxes is not easy to evade by the payer. There is very little possibility of evasion by submitting a false statement of accounts.

5. Social welfare: Indirect taxes can be levied on each item. Some luxurious or harmful goods therefore may be taxed by heavy rate. Thus, it curtails the consumption on such goods or services and increases revenue.

6. Economy in collection: Economy in collection is another advantage of indirect taxes. These are collected by the businessmen from consumers. Public authority has to control only the businessmen not the real taxpayers. Thus, more revenue can be collected at low cost.

7. Appropriate to developing countries: Indirect taxes are more appropriate to developing countries because there are a large number of small taxpayers who are incapable to maintain proper accounts, which is necessary for direct taxes. Thus, more revenue can be collected at low cost.

B. Demerits of Indirect Taxes

Mostly indirect taxes are regressive in nature and are uncertain. Thus, the main drawbacks of indirect taxes can be figured out as under:

1. Regressive in nature: The most important defect of indirect taxes is that they are regressive in nature because they fall on all persons indiscriminately, irrespective of their ability to pay. The poor people feel heavier burden than rich do when mass consumption goods are heavily taxed. Thus, indirect taxes are highly regressive and do not justify the canon of equity.

2. Inequitable: Indirect taxes are regarded as unfair, prejudiced, and inequitable since they are levied to all persons indiscriminately, irrespective of their ability to pay. When mass consumption goods are taxed, the burden will be borne more by poor than by rich people. It is true that indirect taxes can be made progressive and gradations can be introduced but commodity taxes discriminate between people according to their ability to pay.

3. Uncertain: Indirect taxes are extremely uncertain. Taxes on commodities with elastic demand are particularly uncertain, since quantity demanded will be affected by the imposition of taxes. In fact, a higher rate of tax on a particular commodity may not bring in more revenue.

4. Unproductive: In practice, many types of indirect taxes are taken into account as unproductive since these taxes involve more expenses in contrast to contribution on revenue.

6. Inflation grower: Indirect taxes are added on the cost of product. These inflate the cost of product and reduce the purchasing power of people. Thus, they are considered as inflation grower taxes.

7. Tax evasion: The tax evasion also exists in indirect taxes. Seller may evade taxes by making understanding with buyer without issuing invoice. Thus, tax evasion may exist considerably while applying indirect taxes.

8. Unable to develop civic consciousness: Indirect taxes do not create any social consciousness. The taxpayers, in most cases, do not feel the burden of taxes as they have paid. Indirect taxes are paid through the seller where indirect taxes are included in the price of the product. Therefore, the taxpayers are not conscious about payment of tax to the government.

1.3.2 On the Basis of Structure

Economists have classified taxes into four types based on tax rate structure. In case of progressive tax system, the tax rate (the proportion of earnings taken in taxes) is greater for higher incomes. In case of regressive tax system, people who earn less pay a larger part of their income as tax than people who earn more. In case of proportional tax system, all people pay same percentage of their earnings in taxes.

Tax rates and tax base are equally important to determine a taxpayer's liability. The concept of ability to pay and benefit received when taken together while using the concept of equity and justices have led to the well-known controversy between proportional and progressive taxation. The justice of taxation is the main problem among the taxes. However, these classifications keep separate significant relation in taxation. State may adopt different forms within a tax system. A direct and an indirect tax may be progressive, moderately progressive and highly progressive. Proportional tax may be high, moderate, or low. In conclusion, any type of taxes may be levied at any rate structure.

☐ Progressive

A progressive tax is a tax that takes an increasing proportion of income as income rises. In other words, in a progressive tax the tax rate increases with increase in income. Taylor (n.d.) points out that:

> As taxable income rises under progressive taxation, the effective rate of tax rises for marginal increment of income subjected to higher tax rates. This means that rise in tax liability is more than proportional to rise in income. Conversely, as personal income falls, the effective rate of taxation falls and decrease in tax is more than proportional to the decrease in income.

The stated definition clears that in progressive tax, a number of tax rates are fixed according to the level of income. An example of progressive tax

rate structure is deduced in Figure 1.2. Thus, in progressive tax, the tax takes a larger percentage of income from high-income groups than from low-income groups.

A. Merits of Progressive Tax

Progressive tax is popular worldwide due to the following merits.

1. **Equitable:** Progressive tax is based on the principle of ability to pay. In such case, the wealthier person pays progressively more. Thus, the burden of tax spread on different level of people according to their ability and is considered as equitable.

2. **Economy:** In progressive tax, there is no symmetrical increment relation between administrative expenses and collection of revenue. Thus, the cost of collection gradually becomes low relative to the yield.

3. **Flexible:** It is flexible according to its nature. In progressive taxation, there exists some level of tax brackets for each tax rate. These rates are not rigid for tax purposes. The government can easily move to the tax rate when realizes to increase or decrease or adjust its volume of tax among each tax brackets and rates. Thus, progressive tax is well thought-out as flexible.

4. **Inflation preventive:** Progressive tax prevents inflation. Thus, it reduces the consumption of luxurious goods and maintains low disparity in the society.

5. **More productive:** Progressive tax is more productive. It increases the economic activities and these activities automatically increase the government revenue. Thus, the collected revenue can be invested by the government to productive sectors and these sectors give more revenue in the following years. Thus, progressive tax is more productive to a State.

B. Demerits of the Progressive Tax

Progressive tax entails the following demerits:

1. **Difficult to common people:** Progressive tax is very difficult to understand by common people. It can have a number of progression limits to calculate tax liability from tax bases. Thus, it needs the help of expert.

2. **Discourage surplus:** Progressive tax encourages consumption before payment of tax. Higher the consumption lowers the surplus of income and creates symmetrical relation on capital formation.

3. Tax evasion: Progressive taxation influences tax evasion because people with high income have to pay proportionately more tax than people with low-income. Tax evasion is not tax avoidance. Tax evasion and tax avoidance are quite different. Wikipedia (2006) cites:

> Tax evasion is the general term for efforts by persons and companies to evade the payment of taxes by breaking the tax code. It contrasts that tax avoidance is the legal exploit of the tax regime to ones own advantage.

Thus, the progressive tax encourages evasion rather than avoidance.

4. Punishment to earners: In fact, to earn more is not crime. It punishes high-income people imposing proportionately more tax and it rewards low income and idle ones by imposing proportionately less tax. Thus, progressive tax rewards the idleness.

☐ Proportional Tax

A tax is proportional if the rate of tax remains constant for any given income level. In other words, a tax that takes the same percentage of income from all income groups is known as proportional tax. An important feature of tax system is whether they are flat or proportional the percentage does not depend on the base. Hence, the tax is proportional to how much someone earns, possesses or spends. Therefore, proportional tax entails unique rate at all level of income.

A. Merits of Proportional Tax

Proportional tax entails following merits:

1. Simple: Proportional tax is very easy to apply, calculate and communicate to taxpayers. Thus, this classification is easy on taxation.

2. Proportional sacrifice: Proportional tax is levied from certain tax rate. It does not discriminate rich and poor. Thus, under the proportional tax, every taxpayer should pay his/her share from his/her respective income proportionally.

3. Surplus initiator: Proportional tax is a surplus initiator among the classifications for the reason that taxpayer shall not be in opposition to normal rate of tax. Thus, it appreciates profit and plays role of capital formation.

B. Demerits of Proportional Tax

Proportional tax involves the following demerits.

1. **Inequitable:** Proportional tax takes the same percentage of income from all income groups but the capacity of income adjustment varies between rich and poor. Thus, equity on the person ends in proportional tax.

2. **Less flexible:** Proportional tax is less flexible compared to progressive tax. The rate of such tax cannot increase beyond certain limit. Thus, proportional tax is flexible.

3. **Ignores ability to pay:** Proportional tax does not seek ability of high or low-income people to pay tax. Under the proportional tax, low-income groups feel heavy burden of tax while high income people feel negligible burden of tax. Thus, it ignores ability to pay.

☐ Regressive tax

Regressive tax is a levy at a rate that decreases as its base increases. In regressive tax, it takes a smaller proportion of an income as income rises. Moreover, a tax hits less well-off people harder than the better off. Thus, it takes a larger percentage of income from low-income groups than from high-income groups. An example of regressive taxation is presented in Figure 1.4:

Regressivity is considered undesirable because poorer people pay a greater percentage of their income in tax than wealthier people. Regressive tax system is not equitable and conflict the principle of ability to pay. Before independence, the British Government imposed regressive tax on "Salt" imposing heavy burden to poor and exempting tax to rich people. However, consumption taxes and sales taxes are usually considered as regressive because of their set rate structures. It is natural to expect that some of those wealthy individuals and organizations who benefit directly and tangibly from a regressive tax can advocate such taxes. Therefore, it is suitable for wealthy and some special interest groups. Some countries have adopted regressive tax system on payroll taxes; value added taxes and sales taxes. In fact, there are numerous lobbies and political groups devoted to regressive taxes. Practically, all detractors of regressive taxation note that a regressive tax effectively punishes the poor for being poor, placing a higher burden on those least able to bear that burden.

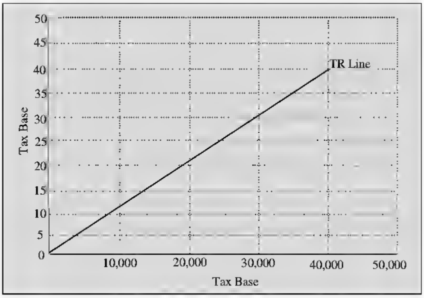
☐ Degressive Tax

Degressive tax is a mixture of progressive and proportional tax. Thus, this tax is also known as mild progressive taxation. The degressive taxation is formulated by the some slab system. Thus, in case of degressive taxation the rate of taxation increases to certain limit and the

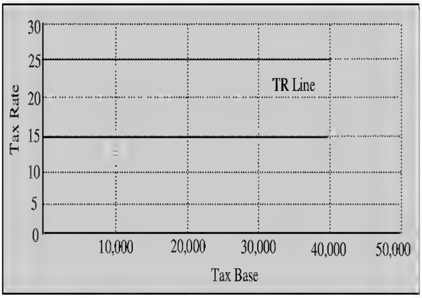
rate remain constant after crossing the limit of income. An example of degressive taxation is presented below in figure 1.5.

Degressive taxation does not maintain equity on taxation. There are specially three type of regressive taxation on the basis of magnitude. It may be highly regressive, moderately regressive and poorly regressive.

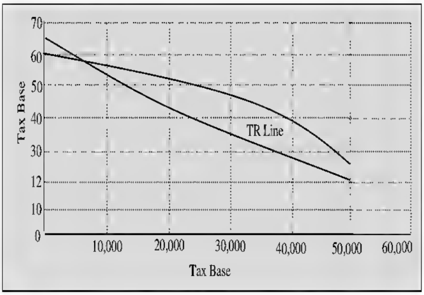
1.2 Progressive Tax



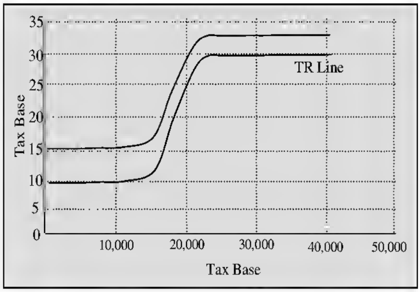
1.3 Proportional Tax



1.4 Regressive Tax



1.5 Degressive Tax



In totality, the higher income group of people has to make little sacrifice in comparison to the lower income groups. In other words, in this taxation, the higher income groups do not sacrifice proportionately more tax according to their ability of income adjustment and ability to pay. Thus, this type of taxation is also not popular in modern world.

1.3.3 On the Basis of Nature

Based on nature, taxes can be classified into various groups: income, property, production, consumption, capital gain and consumption goods taxes etc.

☐ Income Tax

Income tax is levied on the earnings of a person or corporation. Commonly, it is a progressive tax because the tax rate increases with increasing income. It includes employment earnings, interest income, business income, investment income etc. Income taxes provide the

largest single source of government revenues in most developed countries. The revenues generated pay for a substantial part of government operations and services to the public. In Nepal, income tax constitutes around 30 percent of the total tax revenue.

☐ Property Tax

In principle, property tax is a levy on an individual's wealth, the value of person's assets on both financial (stocks and bonds) and real property (houses, cars, and artwork). In practice, property taxes are usually more limited. It is ad valorem tax that an owner of property pays on the value of the property being taxed. There are three types of property: land, improvements to land (immovable man made things), and personalty (movable man made things). In the United States, the state and local governments generally levy property taxes on buildings – homes, office buildings, and factories and land. There is no federal property tax. In Nepal, Property Tax Act, 1991 (PTA, 1991) is only in law book, not in practice. However, Nepal has been using house and land tax since 1960.

The property tax is often unpopular among homeowners because houses are not sold too often and governments levy tax on the estimated value of their houses. Some people believe that government sometimes overvalues their houses which results the unfair high property tax burdens.

☐ Production Tax

Production tax is levied by State on value or quantity of production or extraction of natural resources. It includes gasoline tax, gold production tax, crude oil production tax, kerosene production taxes etc. The production taxes are not practiced in Nepal; however, excise duty is levied. Excise duty and production taxes are levied for different purposes.

☐ Consumption Tax

Consumption tax is a levy, which is imposed on sales of goods or services. The most important kinds of consumption taxes are general sales tax, excise tax, value-added tax, and tariffs.

Most of the countries impose these taxes and raise one of the largest sources of State Revenue. General sales tax and excise tax are the largest sources of State Revenue and local governments in the United States, which accounts about 36 percent of their total tax revenues. Similarly in Nepal, value added tax and excise tax constitutes around 65 percent of total tax revenue.

☐ Capital Gain Tax

Capital gain tax is a levy on profit realized upon sale of an asset. It includes gains from sale of financial assets including securities, derivatives, or personal property as capital gains.

> **EXAMPLE 1-6** If a person buys stock worth Rs. 1,000 at the beginning of the year and sells the stock after it increases in value at Rs. 1,200, the person achieves a capital gain of Rs. 200. When the person sells an asset that has gained value, the capital gain is said to be realized, and the gain counted for capital gain.

1.3.4 On the Basis of Essence

Based on essence, taxes can be classified into two categories: specific tax and ad valorem tax. These both are commodity taxes. But, there is significant difference between these two taxes.

☐ Specific Tax

"Movable property was somewhat harder to tap as a source of taxation, but as market places developed, taxes on the sale or transfer of goods became productive sources of revenue" (Encarta, 2007). If a tax imposed as a fixed sum on each article or item or property of a given class or kind without considering its value, that is known as specific tax. In the specific tax, levy is imposed on a commodity according to its weight, size, and length of measurement.

> **EXAMPLE 1-7** If Nepal imposes Rs. 0.25 per kg on rice bran, Rs. 100 per cubic feet on sand, Rs. 50 per cubic feet for concrete, Rs. 100 per cubic feet for granite and marble etc. as taxes while exporting these goods; these are called specific taxes.

The main advantage of specific tax is easy to levy and more convenient to collect the revenue. It is collected either according to the weight of the commodity or according to the size of the unit of commodity.

The main disadvantage of this tax is a greater burden on poor people than on rich people. The reason is that the marginal utility of money for rich people is lower than that for poor people.

☐ Ad valorem Tax

The term "ad-valorem" denotes that in proportion to the value. The ad valorem tax is imposed based on value of property. Thus, the taxes that are based on value are called ad-valorem. Especially, these are imposed on commodity according to their value. Whatever the weight or size of the unit of commodity, the taxes are charged according to their value. In Nepal, several imported commodities are taxed not according to their weight or size but according to their value.

EXAMPLE 1-8 A trader imported 1,000 pieces of watches worth Rs. 750 per piece total of Rs. 75,000. Ten percent tax if imposed on Rs. 75,000, then that is called ad valorem tax.

The main advantage of ad-valorem tax is that it imposes a greater burden on richer classes. From this point of view, it may be more equitable.

The main problem with ad valorem tax is that it is difficult to know the real value of commodity at the time of imposing tax. Generally, the traders understate the value of commodities in their invoices in order to escape the burden of ad valorem tax.

In fact, it is difficult to separate better one between specific and ad valorem taxes. A good tax system should have both according to the nature of commodities.

1.3.5 On the Basis of Volume

Based on volume, taxes can be grouped into two classes: single tax and multiple taxes.

☐ **Singles Tax**

The first defender of single tax Henry George has asserted "any levy that serves as the government's only source of revenue. Generally, it is understood to mean a tax derived from economic rent and used as the sole source of public receipts" (George, 1879).

According to single tax theory, individuals have natural right to own themselves and the property they create. Thus, they have the right to own the capital and consumer goods they produce. In 1879, George claims "land is God-given. Being God-given, none can justly belong to any individual; all land properly belongs to society as a whole."

Thus, a single tax occurs in a system in which the taxes are levied only on one subject. There is only one tax, which constitutes the source of public revenue. The single tax suggests government to grasp up those who create surplus, and tax them accordingly.

However, there are three serious objections against single tax.

- The single tax is very difficult and expensive to collect. It takes equal cost and time to collect tax from low and high incomes.
- It does not provide contribution from the inheritors of wealth.
- It checks saving more than other taxes

In addition, the supporter of the multiple taxation system claims that the single tax system would not produce adequate revenue. Thus, growth of the State certainly might be damaged and welfare of the citizen might be affected.

☐ Multiple Taxes

A multiple tax system refers to those taxations in which taxes are levied on various items, forms and incidences. This multiple system of taxation conflicts with single tax system. The defender of multiple tax system assumes that the contribution of different taxes contribute to achieve different objectives.

A. Merits of Multiple Taxes

Multiple taxes efficiently check the tendencies of tax evasion.
It can reduce inequality of income and wealth.
Some kind of taxation can check weaknesses of other kind of taxation.

- It helps to raise required income for the government.
- It is more flexible than single tax system.

In general, multiple tax system is a preferable tax system. However, it is undesirable to treat multiplicity. It helps to expand the tax net. Therefore, it is better to rely on a few substantial taxes to achieve the bulk of tax revenue.

1.4 HISTORICAL DEVELOPMENT OF TAXATION

History of taxation started with the human civilization. It is also associated with the history of rise and fall of civilization. Rosen (2004) holds that in all civilized societies, a central administration used to collect portions of people's productive output to use as a reserve in hard times in order to provide for the needy and to increase the wealth and power of rulers. Until the modern era, rulers and their administrators would commonly take portions of people's crops with no consideration of costs of farm work. The resources that rulers obtained through taxation allowed them to undertake such activities as building monuments and waging battles. Thus, taxes supported all early civilizations—first in the Middle East, and then all around the world.

☐ Ancient Great India

Rangarajan (1990 p.19) stresses, Kautilya was a mastermind. Kautilya wrote a definitive treatise on economics and government at a time when large parts of the world were sleep in intellectual darkness. He is also known as Vishnugupta, Indian Brahmin minister and close adviser to *Chandragupta* of the *Maurya* dynasty, and author of the Sanskrit treatise on politics and economics known as the *Arthashastra.*

Indian Council for Historical Research concluded that the *Arthashastra* was a compilation made by a scholar, Kautilya, in 150 A.D. The

Arthashastra includes different types of cash and kind taxes as mentioned below:

- Custom duty (sulka), which consists: (a) import duty (pravesya) (b) export duty (nishkramya) and (c) octroi and other gate tolls (dwarabahirikadeya),
- Transaction tax (vyaji) including manavyaji (transaction tax for crown goods),
- Share of production (bhaga) including 1/6th share (shadbhaga)
- Tax (kara), in cash,
- Taxes in kind (pratikara) including: (a) labour (visti) and (b) supply of soldiers (ayudhiya),
- Countervailing duties or taxes (vaidharana),
- Road cess (vartani),
- Monopoly tax (parigha),
- Royalty (prakriya),
- Taxes paid in kind by villages (pindakara),
- Army maintenance tax (senabhaktham) and
- Surcharges (parsvam) (p.262).

☐ Ancient Egypt

In ancient period, tax collectors were known as *scribes* in Egypt. They taxed even on cooking oil to collect the adequate revenue from citizens. Charles Adams (as cited in Mann, 1992) wrote 'Fight, Flight and Fraud': the story of taxation. This book concludes that the events of Ancient Egypt as:

> Continual tyranny of Egyptian tax collectors created a nationwide decline in incentive. Egyptian workers and farmers lost their desire to work: agricultural lands fell into disuse, businesspersons moved away and workers run away. Sound money disappeared as an influential inflation destroyed the capital.

It is a strong evidence of taxation of ancient Egypt.

☐ Ancient Greece

Adams stresses that in time of war, the Athenians imposed a tax referred to as *eisphora*. No one was exempt from tax, which was used to pay for special wartime expenditures. Athenians imposed a monthly poll tax on foreigners, people who did not have both an Athenian mother and father, of one drachma for man and a half drachma for women. The tax was referred to as *metoikion*.

☐ Roman Empire

The earliest taxes in Rome were customs duties on imports and exports called *Portoria*. Augustus instituted an inheritance tax to provide

retirement fund for the military. The tax was five percent on all inheritances except gifts to children and spouse. The English and Dutch referred to the inheritance tax of Augustus in developing their own inheritance tax.

During the time of Julius Caesar, one percent sales tax was imposed. During the time of Caesar Augustus, sales tax was four percent for slaves and one percent for everything else.

Adams stresses that the prevalence of great damaging taxation prior to the fall of Rome has led many historians, in all ages, to suspect that Rome, like so many great empires, taxed itself to death.

Adams concludes finally: *Moslem* taxmen ended up rivaling the worst of the Roman Empire. Perhaps this picture of Moslem tax chiefs, written centuries ago, best illustrates the end product of their tax system: They were cruel misbehavior, inventors of a thousand injustices, arrogant and presumptuous.

☐ Great Britain

In 1215 A.D., King John of England was compelled to sign the *Magna Carta.* It was a charter of liberty obtained from King. It guaranteed free trade to merchants within England and it established the principle of "separation of powers".

Adams explains that the situation of the king and parliament—the king could spend but not tax and the parliament could tax but not spend. As long as the power to tax and the power to spend were separated and the rights of Englishmen would live forever, especially the right to be free from oppressive taxation. In fact, the current runaway taxation is the natural corollary of our desertion of that ancient English practice.

Rosen (2004) concludes, administrators in England attempted to collect the first true income tax, a tax on wages, in 1404, but the public quickly demanded its repeal, and all tax records were burned. Very less number of scholars knew about this tax because parliament had every written document and record about how it destroyed. Evidently, a significant number of people recognized it for the evil it was. A short poem about it did survive:

> A monstrous birth shown to the world, to let it know what could be done, and concealed by historians, and the world might not know what may not or ought not to be done (Mann, 1992).

In December 20, 1798, a popular newspaper, “The Times” writes,

> The idea of a tax levied by a government on the income of individuals and business firms was not a new one, as it had already been introduced in Revolutionary France in 1793 (as cited in Microsof Encarta, 2007).

Modern forms of income taxation date to a British income tax levied in 1799. This tax raised revenues for the Napoleonic Wars against France, which Britain and a coalition of other European nations won in 1815. According to Adams, the tax returns of this law show a remarkable similarity to the returns of the modern tax law. This law adopted 10 percent income tax on a temporary basis, to be removed six months after the war ended with Napoleon. By popular demand, the income tax of 1799 was withdrawn by a large majority repealing a second income tax in 1816. All of these tax records of the income tax 1799 were also burned.

The Parliament of England ordered to the 1404 income tax and all the government income tax records shattered. In 1842, Sir Robert Peel adopted a temporary three percent income tax, which was "supposed to be repealed as soon as government revenues were in balance". Peel admitted, a certain grade of inquisitorial scrutiny is inseparable from an income tax. William Gladstone was determined to close down the income tax. Mann further points out that:

> During the nineteenth century, the German States also introduced income tax. Unlike the British, the Prussian system summoned taxpayers before revenue authorities for examination. All taxpayers were required to declare and pay their tax. Prussian observation was so extensive that one German legislator declared, the country is covered with a perfect system of intelligence. Seligman dismissed the Prussian system as an aberration. In a few short years, this observation by the leading tax expert in America would be contrary to the course of development of every income tax system in the world. The spirit of Britain's modest income tax would become outmoded and unworkable; while the spirit of the Prussian income tax system would soon infect every nation on earth (1992).

☐ American Tax War

Adams points out that American Civil War—more accurately, "the Rich Man's War and the Poor Man's Fight"—was caused by taxation. It was called the "American Tax War." At the time, the South paid about three-quarters of all federal taxes. The tax system shifted wealth from the South to the North. The proverbial "straw that broke the camel's back" was the Morel Tariff, passed by Congress in 1861, and signed by

Abraham Lincoln. Jefferson Davis, the first president of the confederacy, justified secession in his inaugural address by making reference to the Declaration of Independence then emphasizing the import tax issue." The North, led by Abraham Lincoln, practiced economic rape against the South. The Civil War was fought over taxes, not slavery.

The year 1894 may have been civilization's most important tax year. Britain adopted new death duties with progressive rates and the United States adopted an income tax. The progressive rates in Britain soon applied to income taxation everywhere. The taxing habits of civilization would never be the same again.

☐ Pay-Tax-As-You-Earn System

Sir Kingsley Wood piloted Pay-Tax-As-You-Earn (PAYE) system of Tax. In 1944, the Great Britain introduced this system. It replaced annual or twice yearly collections system of the Great Britain. In beginning, employers deducted tax and when an employee left an employer, they gave a code number, income to date and tax paid to date to the employee in PAYE system.

REVIEW QUESTIONS AND CASES

1. What is tax? Briefly discuss principles of good taxation.
2. "The term taxation and tax are quite different." Do you agree with this statement?
3. What are the principles of taxation? Elucidate any two principles of taxation.
4. What do you know about the "principle of ability-to-pay"? Explain with examples.
5. "Tax rates that are too progressive- that rise too steeply- may discourage both work and investment by removing much of the reward." Elucidate this statement.
6. Critically examine various taxes under tax rate structure.
7. Comment on Adam Smith's canons of taxation.
8. Ad valorem taxes are more equitable than specific taxes. Comment.
9. "Fairness is the most essential requirement of principles of taxation". Explain.
10. Proportional taxes are more equitable than progressive taxes. Comment.
11. Write short notes on the following:
    (a) Indirect taxes
    (b) Direct taxes
    (c) Regressive tax

(d) Degressive tax
(e) Single tax and
(f) Multiple taxes.

PART

2

Basic Concept of Income Taxation in Nepal

Chapter 2

Basic Concept of Income Taxation in Nepal

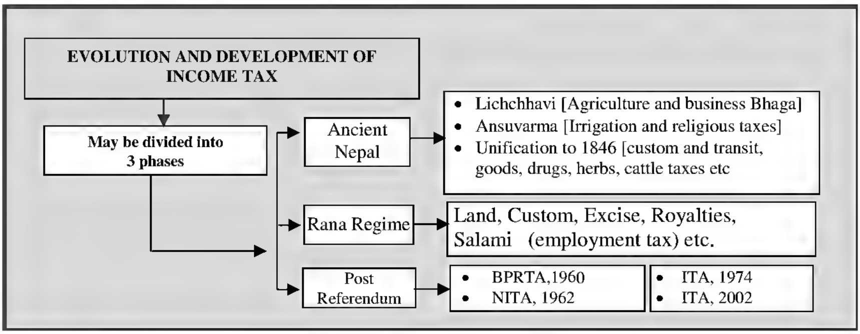
2.1 EVOLUTION AND DEVELOPMENT OF INCOME TAXATION IN NEPAL

The income tax is a modern development. Microsoft Encarta cited that the earliest instances of a general income tax were those levied in France in 1793, in Great Britain in 1799, in Switzerland in 1840, in Austria in 1849, and in Italy in 1864. In United States of America, it was levied in 1862 at first, during the American Civil War, but was abandoned a few years later. In 1894, the US Congress adopted an income tax on individuals and businesses at a rate of 2 per cent; the US Supreme Court declared this levy unconstitutional in 1895. Consequently, a constitutional amendment was required to give full legal sanction to

federal use of an income tax. With the ratification in 1913 of the 16th Amendment to the Constitution, the United States joined numerous other nations—including Germany, the Netherlands, Australia, New Zealand, and Japan—in taxing incomes.

History is a presentation of facts written and given out of past phenomenon. It reveals facts of past events, which may be central supporting gist for educating, guiding and directing to new generation to activate towards the development activities. However, historical background of economic activities of Nepal is not long. The history of revenue activities of ancient Nepal is not systematic. Proof and evidence of tax system depends upon different public statement made by different dynasties who ruled over Nepal. Thus, the history of tax system started since Lichchhavis dynasty. Considering its evolution, the whole history of taxation of Nepal can be divided into three major phases as ancient Nepal, Rana regime and post referendum.

Figure 2.1: Evolution and development of income tax in Nepal



☐ Ancient Nepal

Taxes have been one of the primary sources of government's revenue from ancient time in Nepal. During that period, taxes were levied on farmers, merchants and travelers in the form of cash or kind. Labor and goods were types of taxes. The fiscal administration during the Lichchhavi and Malla regime is of remarkable importance. In Lichchhaviregime, direct taxes were introduced for the first time in Nepal. At that time, direct taxes were imposed on agriculture and business income. These direct taxes were copied from 'Kautilya's the Arthashastra'. Thus, taxes on agriculture income were called *Bhaga* (share of production). According to quality of land owned by farmers, the levy was prescribed as portion of one-sixth, one-eighth and one-twelfth on their total production. It was tax on income, not on profit. The levy on income from business—called *Kara*—was a tax in cash. It was also

copied from 'Kautilya's the Arthashastra'. King Anshubarma of the Lichchhavi dynasty levied agriculture and religious taxes in ancient Nepal.

Malla dynasties are also reasonably important for the tax system in ancient Nepal. They introduced a new tax—*called Potaka*—that was received for defense contribution. It was levied on water of farmers' irrigation.

Shah dynasty ruled over Nepal since 1968 assembling the State governments of Nepal for the Centralized Government. After assembly (1768 A.D.) and before starting of Rana regime (1846 A.D.), Nepal exercised and experienced a variety of taxes to generate maximum revenue for the government. In the beginning, taxes were levied on land, transit, market duties, forest product and mine. Those taxes were both cash and kind. Those were imposed and collected from three levels: royal palace, central government and local government bodies. They levied and collected taxes without law. In case of levy collection, they did not show any human behavior. The taxes were collected by coercion for maximum government revenue. During that period, taxes were also levied on custom, transit, jewelry, blankets, copper, iron, papers, textiles, yak-tails, drugs, herbs, cotton, cloths, sheep, goats etc. However, direct taxes on land (capital) and business (income) were major sources of that period.

☐ Rana Regime

In 1846 A.D. (1903 B.S.), Jang Bahadur Rana became Prime Minister of Nepal through *Bhandarkhal* Massacre. Then, he and his family ruled over Nepal for 104 years. This period (1846-1950 A.D.) is known as Rana regime. In their regime, taxes were also levied and collected according to Prime Minister's will, willful power and order. There was not any law. They never prepared government budget. The budget of the State was budget of the Prime Minister. Therefore, they built palaces for them from excess revenue of the State. Their government took pleasure in public revenue and never concerned to mobilize available financial resources to develop the country. They levied tax upon land, custom, excise, royalties, etc. They introduced tax on employment income—*called Salami*—in Nepal. However, it was collected from government employees only. In their regime, customs and excise duties were collected but the major source of government revenue was levy on land.

☐ Post Referendum

Before 1951(2007) two dynasties—Shah and Rana—ruled over Nepal. In 1950, Nepal introduced in limit referendum when Rana Dynasty fell down and started multiparty democracy system under Shah Dynasty. The first government of post referendum thought to put income taxes in Nepal. However, the crafty and deceitful king Tribhuvan and Prince Mahendra succeeded to fail thought of the cotemporary government. In 2011, King Tribhuvan died in Switzerland and Mahendra ascended the throne. Despot King Mahendra lingered to introduce income tax Act in Nepal and it lasted up to 1959 AD.

In 1959, the contemporary government introduced income tax as the provision laid down in Finance Act of 1959. In the provision, there were only two income heads: remuneration and business. In this income tax, rates were put in order 5 to 25 percent fixing 10 brackets. It contained the provision of concession to large and small-scale industries. The concession rate was 25 percent for large-scale industry and 50 percent for small-scale industries on their tax liabilities. In 1960 A.D. (2017 B.S.), a formal income tax Act Business Profits and Remuneration Tax Act, 1960 (BPRTA, 1960) was enacted in accordance to the provisions of Finance Act, 1959 (2016) for the first time in Nepal. It was the first from various attitudes: prescribed by the elected government, passed by elected members of the Parliament, and responsible towards people. It had altogether 22 sections. It had defined the terms: business, profit, remuneration, company, firm, assessment, tax realization, tax exempt person, tax exempt area, taxable income, tax deduction at source, submission of income statement, rights of tax officer, method of assessment, payment of tax, fine, penalties, tax officials, secrecy etc. However, it was neither equitable nor fair. This act was exempted to income of palace and the king. It existed until to 1962.

Despot king Mahendra—a mastermind of Dictator Panchayati System—dismissed the Parliament in 1960 and criticized the existing tax law as narrow, unclear and vague. Nepal Income Tax Act 1962 (NITA 1962) replaced to BPRTA 1960 in 1962. It had altogether 29 sections. It had nine income heads: (1) business; (2) remuneration; (3) profession and vocation; (4) house and land rent; (5) cash or kind investment; (6) agriculture; (7) insurance business; (8) agency business; and (9) other source.

NITA 1962 defined the terms: taxpayer, tax officer, company, firm, business, profit, remuneration, profession or vocation, house and land rent, cash and kind investment, agriculture, assessment, person, couple, family, partnership firm, non-resident, and temporary resident. In

addition, it included some new provisions methods of tax realization, tax exempt person, tax exempt area, tax deduction at source (only on remuneration), submission of income statement, constitution of assessment committee, method of payment of income tax, computation of net income, appeal, secrecy, agreement with foreign country, setoff and carry forward of losses, tax base etc. In §26, the absolute monarch deceivably anticipated that would not apply to the private purse of His Majesty King. One year later, he enacted Income Tax Rules, 1963 (ITR, 2020).

The prominent objectives of NITA 1962 were that: (1) to reduce unequal distribution of wealth, (2) to make impartial, (3) to guide by fairness and (4) to establish behavior of payment of tax. It amended in 1972 (2029) and continued until 1974 (2031). In 1974, Income Tax Act 1974 (ITA 1974) replaced to the NITA 1962.

The king Birendra enacted ITA 1974. It was also enacted under absolute monarchism of Panchayat regime. In starting, it was claimed to be specific and scientific. It had altogether 66 sections and sub-sections. It contained five income heads: (1) agriculture; (2) remuneration; (3) industry, business, profession or vocation; (4) house and land rent; and (5) other source. It was amended in 1977, 1979 1980, 1984, 1985, 1986, 1989 and 1992 to make effective, practical and to avoid confusion. In 1982 (2039), His Majesty's Government (self declared) enacted Income Tax Rules, 1982 in accordance to the authority given under §65 of the Act. It added two new provisions of self-assessment and carry forward of losses for three years. It clearly defined the terms: tax; taxpayer; assessment; tax officer; income year; assessment year; firm; company; net income; gross income; preliminary expenses; person; couple; family; Director General; philanthropic work; temporary resident etc.

However, this Act had some shortcomings: limited tax base, lack of integration, unclear and vague, willful power of tax officer and government, inequitable among taxpayers, unscientific presentation, lack of control in tax evasion and dual appeal system.

Moreover, it had no reasonable preamble. Content of preamble was in a short sentence as, "Whereas it is expedient to amend and consolidate legislation relating to the taxation" (ITA, 1974). It was advantageous for practical rather than moral reasons. Income Tax Act 2002 (ITA) replaced ITA 1974 in 2002 (2058). It came into effect on April 1, 2002 (Chaitra 19, 2058). It is a second income tax Act passed by the elected members of the Parliament in the history of Nepal. The Government of Nepal (at that time called His Majesty's Government of Nepal) enacted Income

Tax Rules 2002 (ITR, 2002) in 2002 (2059) as the provision laid down in the ITA 2002. The ITA 2002 seeks its objectives in its preamble as:

> In order to enhance revenue mobilization through effective revenue collection process for the economic development of the nation, it was imperative to make the laws on income tax in order to update, amend and integrate them (p. 2).

It is an integrated income tax Act of Nepal. Thus, it aims: (1) to tax all sources of income, (2) to tax according to equality (3) to make practicable tax system, (4) to develop extensive, clear, transparent, simple and efficient tax system, (5) to make responsible to tax officials, (6) to develop tax system as a neutral tax and (7) to stress accounting and self assessment.

However, foregone aims are limited on the policy and paper only. The Act contains some shortcomings: (1) it was unjustifiable (exempted income tax on palace and the king before the declaration of the Parliament in 2063), (2) it does not complete principle of equity and fairness (adopts only flat and two tiers tax rates), (3) it does not cover total incomes of a person (assumes that incomes produce only from the factors of production), and (4) it assumes that the taxpayers are rational and they pay their taxes according to law.

2.2 FEATURES OF INCOME TAX ACT 2002

Income taxation plays a crucial role in national economy and income tax is a major revenue source of the government. It is believed that a tool for acquiring adequate revenue to achieve social and economic objectives of the nation. It is also accepted as a good financial lever to reduce inequalities of income among various levels of people. In addition, it also helps to reduce regional economic disparity creating incentives and concessions in income tax while starting new industries in financially back areas. Thus, income tax is a major source of revenue and has become an effective instrument to ensure balanced socio-economic development.

Present income tax law of Nepal comprises ITA 2002, ITR 2002 with amendment and Finance Act, 2006. The ITA came into force on April 1, 2002 and now a day it has been enacting all over Nepal. It governs calculation of the total income, powers of tax authorities, procedure of assessment, appeal, penalties, suit, refund of tax, rectification of errors etc. It has 143 sections and subsections.

Every year the Parliament passes Finance Act mentioning tax rates, provision of withholding and method of payment of tax for respective

year. It amendments Act to some extent. The Finance Act, 2063 is also a continuity of this practice.

Every tax law bases on some qualities and assumptions and it does not contain the exception. It contains the following underlined features:

☐ **Act of Compilation of all Provision of Taxes**

It is a compilation of dispersed provisions of various Acts regarding to income tax. It supersedes other Acts except the Constitution. Income tax related provisions, which are laid down in other Acts, are explicitly frozen by this Act. Thus, this Act fulfills a code of conduct on the tax matters.

☐ **Equity on Tax Rate**

It completes the principle of horizontal equity due to the unique tax rate for the unique types of income irrespective of place, power and class.

☐ **Long-Term Vision**

It seeks long-term vision on incomes and expenditures. Thus, it entails a long list of income and flexible titles of costs and expenses that are progressive in nature. This nature of income tax can exist for a long-time with amending its provisions by financial Acts.

☐ **Deduction of Real Expenses [§13]**

It commits to deduct all real expenses, which are incurred while earning, or receiving income excluding some prescribed costs. Thus, the Act commits to deduct expenses: (1) incurred during the year; (2) incurred by the person; and (3) incurred for receiving or earning of income from business or investment.

☐ **Deduction of Losses**

The Act treats loss as an expense. According to Act, business loss may be offset, carry forward and back for the year(s). However, the duration of carry forward and back depends upon nature of business. But, loss of investment income may be off-set for the year from other investment.

☐ **Incentives to National Priority Industries [§11]**

The Act imparts high priority to the national infrastructure industries. It differentiates as well as provides incentives to those industries, which are established in the areas of: least developed, undeveloped and underdeveloped. Moreover, it also allows some benefits to special industries as well as industries, which employ more than 600 Nepali citizens.

☐ **Based on Completely Self-Assessment System**

ITA 2002 has approved completely self-assessment system. According to this system, taxpayers require to declare and submit his income statement annually. The statement should disclose at least earned income, incurred expenses as per act, paid tax and tax to be owed. In this system, the role of tax authority is to check taxpayer's statement of income. The submitted income statement of taxpayer is taken as true and fair if it is not proved otherwise. In case of non-submission of income, statement by taxpayer withholding amount is taken as payment of tax. But, in case of false statement and evasion of taxes by the taxpayers, the Act entertains stringent actions.

☐ Clear Treatment of Civil Case

The Act is particularly clear in between civil and criminal case. The cases of tax like fraud, fraudulent, misappropriation, understating of income, over stating of expenses, splitting of income, undue influence to tax authority etc. are treated as crime of civil case. According to the Court decision fine, penalty and imprison may apply to the guilty taxpayers.

☐ Provision of Revision and Appeal

ITA 2002 contains two appeal systems: administrative review and appeal to judicial. The administrative revision also holds two tiers: field tax office and appeal section of the IRD. These levels contain administrative revision of levy while first judicial level (Revenue Tribunal) judges decision of department. However, ultimate decision concerns a writ petition filed at the Supreme Court.

☐ Withholding

ITA 2002 is based on Pay-Tax-As-You-Earn (PAYE) system. The PAYE system concerns for extreme withholding. Withholding payment is required on the subject of employment, investment and service fee and contract business. Again, withholding is put in order to final and non-final.

It assumes the principles of complete equity of taxation.

☐ Method of Accounting

ITA 2002 follows Generally Accepted Accounting Principles (GAAP) for method of accounting in general state of affairs. It is an international accounting standard and the most countries follow it. However, method of accounting also concerns to income heads. Employment and investment income of an individual is forbidden for accrual basis.

☐ Ceiling to Specific Costs

ITA 2002 applies method of ceiling for specific costs. According to the provision laid down in the act; pollution control (PC) costs, research and

development (R&D) costs, repair and improvement (R&I) costs, interest (paid to exempt controlled resident entity) and losses are subjected to specific costs. These costs are concerned for the certain ceiling. Though, donation does not complete norms of expense but it is deducted from the income up to prescribed ceiling based on statutory provision.

□ Classification of Persons

ITA 2002 follows new system of classification for taxpayers. For this purpose, it has two broad classifications: individual and entity. Both these classifications contain several elements for taxpayers. It considers 'exempt entity' as a person and 'sole proprietorship firm' an individual.

2.3 DEFINITIONS OF RELATED TERMS

A definition describes the basis of integration of a specific concept. It describes the essential nature of the concept. It differentiates all other particulars from those included under the concept. In law, definition of a term plays an important role in giving correct theoretical expression. It always guides readers about its meaning. Therefore, the concept of definition is important to understand the subject matter of any law. Various philosophers have defined definition in different ways. Some of the important definitions of definition are mentioned below.

In 1990, Campbell, Nolan, and Jacqueline state that definition is:

> A description of a thing by its properties; an explanation of the meaning of a word or term or the process of stating the exact meaning of a word by means of other words and such a description of the thing defined, including all essential elements and excluding all nonessential, as to distinguish it from all other things and classes. (p.423)

Encarta Dictionary (2007) defines, "meaning of word; a brief precise statement of what a word or expression means". Alternatively, a definition is an "act of defining a word; the act or process of defining what a word or expression means". Similarly, Ayliffes (as cited in Bouvier, 1856) defines that:

> An enumeration of the principal ideas of which a compound idea is formed, to ascertain and explain its nature and character; or it is that, which denotes and points out the substance of a thing, to us.

This dictionary also mentions additional issues, characteristics and limitations for the definition as:

- A definition ought to contain every idea, which belongs to the thing defined, and exclude all others.

- A definition should be:
  - (a) Universal, that is, such that it will apply equally to all individuals of the same kind.
  - (b) Proper, that is, such that it will not apply to any other individual of any other kind.
  - (c) Clear, that is, without any equivocal, vague, or unknown word.
  - (d) Short, that is, without any useless word, or any foreign to the idea intended to be defined.
- Definitions are always dangerous, because it is always difficult to prevent their being inaccurate.
- All ideas are not susceptible of definitions, and many words cannot be defined. This inability is frequently supplied, in a considerable degree, by descriptions.

An explicit definition provides a clearer understanding of a concept. It allows a more complex manipulation and use of the concept. It also allows communication of what the concept is. Thus, a term is used with a particular meaning in a particular circumstance and it becomes very particular in particular law. No law can understand without knowing the meaning assigned in the relevant Act. Thus, ITA 2002 consists the following particular terms for particular meanings.

☐ Income [§2(h)]

Income means a person's income from any employment, business or investment and the total of that income. Income denotes total receipt, which are included in calculation of taxable income. This definition does not disclose items of income.

In Bouvier's Law Dictionary, the term income is defined as, "The gain which proceeds from property, labor, or business; it is applied particularly to individuals; the income of the government is usually called revenue".

This definition points out two things: income is gain of individuals and revenue of the government. Similarly, a familiar definition can be found in an electronic journal "Total Tax Solution". "Money or its equivalent, earned periodically by an individual, a corporation, etc., in return for goods or services provided." This definition denotes income as return of goods or services. In Income Tax Act of India, income includes:

> Profits and gains; dividends; voluntary contributions received by a trust crated wholly or partly….; the value of any perquisites or profit in lieu of salary…..; any special allowance or benefit, other than perquisite included…specially granted to the assessee to meet

> expenses wholly, necessarily, and exclusively for the performance of the duties of an office or employment of profit; any allowance granted to the assessee either to meet his personal expenses….; the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company….; the value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee…. or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee….(beneficiary) and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary; any sum chargeable to income tax…; any capital gains…; the profits and gains of any business of insurance…..; any winning from lotteries, crossword puzzles, races…..; any sum received by the assessee from his employees as contributions to any provident fund……; any sum received under a keyman insurance policy……;…..(Income Tax Act, 1961; pp.1.14-1.15).

However, the Indian Act also does not express clear concept of income. It is an inclusive definition of income.

In Black Law Dictionary, Campbell, Nolan, and Jacqueline (1990) state that:

> The return in money from one's business, labor, or capital invested; gains, profits, salary, wages, etc. The gain derived from capital, from labor or effort, or both combined, including profit or gain through sale or conversion of capital. Income is not a gain accruing to capital or a growth in the value of the investment, but is a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, an coming in, being derived, that is, received or drawn by the recipient for his separate use, benefit, and disposal (p. 763).

As the above stated definitions, the term income is used in several ways. Some use the word interchangeably with revenues. Others use the word to signify a net amount, such as income from operations. Still others use it when referring to non-operating revenues, such as interest income. Thus, in general, the term income means the return in any amount of cash or king from one's business, labor, or capital or any combination of factors of production.

□ Principles of Income

Income contains some definite principles as:

1. Regular and definite source: Income indicates periodical monetary return coming in with some kind of regularity or expected regularity from definite source. The income from any source can not be indefinite and unexpected.

2. Different forms of income: Income may be in cash or kind. When it is received in kind, its valuation is to be made according to practice or rules prescribed in the income tax Act. However, if there is no prescribed rule, valuation then promptly is made based on market value.

EXAMPLE 2-1 If a company allotted share to his employees or company directors at face value in the very beginning in lieu of salary, the face value of the share is taken as income from employment of the employees or company directors.

EXAMPLE 2-2 If a company allotted share to his employees or company directors at face in lieu of salary where the market price of share is higher, the amounts of allotted shares are chargeable to tax on the basis of market value.

3. Illegal income: Income tax law does not make any distinction between income earned or received from a legal source and income earned illegally. Illegal income is taxable like legal income. Expenses incurred to earn or receive that illegal income are deductible like expenses incurred to earn legal income.

EXAMPLE 2-3 Any smuggling economic activity if taken as a business, the confiscation of currency notes by customs authorities is a loss, which springs directly from the carrying on of the business and is, therefore, permissible as a deduction.

☐ Assessable Income [§6]

The computed income (inclusions less deductions) from each income head is assessable in Nepal and it is called an assessable income.

Incomes of any person residing in Nepal are taxable irrespective of the location of its source. This means, incomes of any person residing in Nepal and income through Partnership, Company, Trust or branch of Foreign Entity situated in Nepal is taxable irrespective of the country where the earning activity, say, business or investment was carried out. The income of a non-resident person is only assessable to the extent that it has a source in Nepal.

Income from an agriculture and cooperative business [§11(1) and (2)] and from an approved retirement fund [§64(2)] is exempt from tax and does not belong to assessable income.

Table 2.1: Assessable income

A. Assessable income from business		
Equals	**Total of inclusions from business income**	**××**
Less:	General deduction [§13] Interest [§14] Cost of trading stock [§15] R&I costs [§16] PC costs [§16] R&D costs [§18] Depreciation allowance [§19]	× × × × × × ×
Business income		××
Less:	Unrelieved loss of other business - during the year Unrelieved loss from business - previous years Contingency provision of loss [for financial institution]	× × ×
Assessable income from business		××

B. Assessable income from employment

Equals	Total of inclusions from employment	××
Less:	Nothing	-
Assessable income from employment		××

C. Assessable income from investment

Equals	Total of inclusions from investment income	××
Less:	General deduction [§13] Interest [§14] R&I costs [§16] Depreciation allowance [§19]	× × × ×
Investment income		××
Less:	Unrelieved loss from business or other investment - during the year Unrelieved loss from business - previous years Contingency provision of loss [for financial institution]	× × ×
Assessable income from investment		××

D. Assessable income

Equals	Assessable income from business	×
Plus	Assessable income from employment	×
Plus	Assessable income from investment	×
Assessable income		××

☐ Taxable Income

IBFD (2006) points out that:

> An amount of income on which tax is actually chargeable (i.e. the amount to which the tax rate is actually applied or the net taxable income), or the amount of income from which tax losses, personal allowances and other relief must be deducted before deriving the amount to which the tax rates are applied, i.e. gross taxable income.

The income, to which tax rates are applied, is taxable income [§5]. It is defined as the assessable income less deductions of gifts to exempt organizations [§12] and retirement contributions [§63]. The assessable incomes from those income heads are aggregated for the income year and gifts and certain contributions to approved retirement funds reduced to deduce taxpayer's taxable income for the year.

☐ Adjusted Taxable Income

Adjusted taxable income means an amount of taxable income of a person for an income year calculated by ignoring deductions of donation amounts, payment of interest to tax exempt controlled entity, R&D cost and PC cost. But, it refers different meaning at different situations.

> **EXAMPLE 2-4** Suppose that if a person has single-source and multi-sources with or without interest paid to exempt controlled entity the adjusted taxable income is calculated as:

(a) Adjusted taxable income to calculate R&D and PC costs

Equals	Total inclusions (business income)	×××
Less:	General deduction	(×)
	Interest	(×)
	Cost of trading stock	(×)
	R&I costs	(×)
	Depreciation allowances	(×)
Adjusted taxable income		××

(b) Adjusted taxable income to calculate interest costs paid to tax exempt controlled entity

Equals	Total inclusions (business income excluding interest income)	×××
Less:	General deduction	(×)
	Cost of trading stock	(×)
	R&I costs	(×)
	Depreciation allowances	(×)
Adjusted taxable income		××

(c) Adjusted taxable income to calculate payment of donation

Equals	Total inclusions (business income excluding interest income)	×××
Less:	General deduction Interest expenses Cost of trading stock R&I costs Depreciation allowances	(×) (×) (×) (×) (×)
Add:	Assessable income from investment (if exists)	××
Add:	Assessable income from employment (in case of natural person)	××
Adjusted taxable income		××

☐ **Turnover [§2(p1)]**

Turnover means total amount of transaction for an income year equivalent to a sum of all amounts to be included in calculating income from business or investment for the year under the §7 or §9. Thus, turnover includes the total of inclusions of business and investment activities but excludes the inclusions of income from employment.

☐ **Relatives [§2(w)]**

Relatives means a spouse, children (including adopted children), parent, grandparent, sibling, aunt, uncle, nephew, niece, grand son, grand daughter, brother-in-laws, sister-in-laws, father-in-laws and mother in laws of an individual.

☐ **Natural Resources [§2(ad)]**

Natural resource payment means amounts of any payment for the right to take water, minerals, or other living or non-living resource from the land; or amount as calculated on the basis of quantity or value of a living or non-living natural resource and minerals taken in whole or part from the land.

☐ **Income Year [§2(i)]**

"Income Year" means the period from the first of Shrawan of a year to the end of Ashadh of the following year. It means an income year is a period of 12 months that starts from Shrawan 1 of a year and ends at last of Ashadh of the next year. In some cases, it may be shorter than 12 months.

1. **Income year in case of newly set up and ending of business:** New business may be set up at any date of any income year. Thus, income year starts from the date of setting up of the business and ends at the end of following Ashadh. Therefore, an income year

never exceeds the duration of 12 months but it may be shorter than 12 months.

EXAMPLE 2-5 A group of individual applied to register a Company at Office of the Company Registrar and obtained certificate of incorporation on Magh 1, in an income year. Thus, the first income year of the newly set up Company becomes duration (Magh 1, of an income year to last Ashadh of the following year) of 6 months.

EXAMPLE 2-6 An individual natural person registered a firm under the Firm Registration Act, 2014 at Office of Cottage and Small Scale Industry and obtained certificate on Magh first, in an income year. But, neither had he taken Permanent Accounts Number (PAN) nor he operated his business till the end of Shrawan of the following year. On Bhadra first, he took PAN and same day he started to operate his business transaction. For the firm, thus, the first income year becomes the duration (Bhadra first, to last Ashadh of the following year) of 11 months.

2. Income year under jeopardy assessments [§100]: Under certain specified circumstances, the tax authorities shall make taxpayer to file an early return of income prior to the regular date (prior to Shrawan first of the following year) of filling a return [§96(5)] or, instead, may make an assessment according to the tax administration's best judgment for any time of the year [§100]. Therefore, under jeopardy assessment an income year may be shorter than 12 months. The condition of jeopardy assessment occurs at the following situations:

- If the taxpayer becomes bankrupt, is in over debt, or goes into liquidation,
- If the taxpayer is about to leave Nepal for indefinite duration,
- If the person is about to cease the ongoing activity in Nepal owing to any reason, or
- If the Inland Revenue Department (IRD) otherwise considers it appropriate.

EXAMPLE 2-7 A person is in over debt since he is going to liquidate his business firm immediately and in near future, he is going to leave Nepal. The Inland Revenue Office (IRO) knew this state of affairs of that person and ordered him to submit his tax return file upto the last of Chaitra of the current income year. In this case, he becomes liable to follow order. Thus, in this position his income year for that year becomes the duration (Shrawan 1, to Chaitra 31, of the current year) of 9 months.

☐ Assessment Year

Assessment year means the period of 12 months. It becomes neither shorter nor longer than 12 months. It starts from the first day of Shrawan of every year and ends at the end of Ashadh of the following year.

> **EXAMPLE 2-8** If a person earned income Rs. 15 million from his window business in an income year and according to law he has to submit his income tax return in the following income year. Thus, for him, the assessment year is the following year of the income earned year.

☐ Previous Year

Income earned in a year is assessed in the following year. The year in which income is earned is known as previous year and the following income year in which income is assessed is known as assessment year.

> **EXAMPLE 2-9:** If any income earned in any income year it is assessed in the just following income year. In the case of income tax, the income earned year is the previous year from assessment year.

☐ Payment [§2(ag)]

Payment means an amount of money that is paid or is due to be paid including the following transactions.

- The transfer of money or an asset by one person to another person or the transfer of liability by another person to the one;
- The asset created by one person if on creation is owned by another person or when the liability of one person is borne by another person;
- The provision by one person of services to another person; and
- The use or availability for use of an asset owned by one person to another person.

☐ Incapacitated Individual [§2(g)]

Incapacitated individual means an individual who, by reason of mental or physical illness, is incapable of managing their affairs (p. 3).

☐ Gift [§2(j)]

Gift means a payment that is without consideration or a payment with consideration to the extent the market value of the payment exceeds the market value of the consideration.

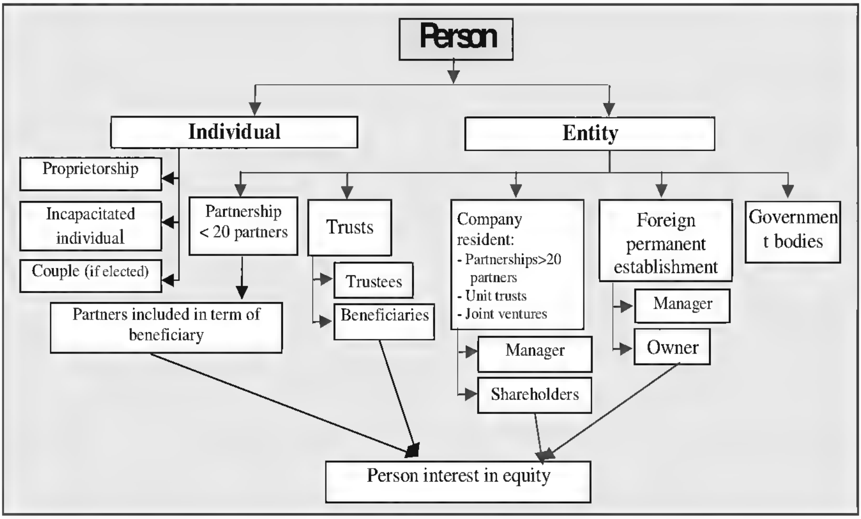
☐ Person [§2(ap)]

In the most common sense, a person is “a human being regarded as an individual”. Beyond the general definition, in taxation law it includes an

entity. Thus, entity is a person having a distinct identity with certain distinguishable and persistent characteristics.

ITA 2002 classifies taxpayers into two broad persons: individual and entity. The individual person includes three types' income earners. Similarly, the entity includes fourteen types of income earners. However, element or of the income earner is neither taxpayer nor person. We have to understand that there are only two persons: individual and entity. The term person implies each taxpayer irrespective of its status (natural or artificial) and place.

Figure 2.2: Classification of person



1. **Individual [§2(ac)]:** Individual means a natural person and the term also denotes any proprietorship firm, whether registered or unregistered, owned by an individual if any, and a couple eligible as a single natural person according to their choice.

EXAMPLE 2-10 If an individual owns a small shop it is taxed as a proprietorship firm irrespective of its status, whether registered or not in concerned authorities. Thus, term 'individual' signifies to proprietorship firm, incapacitated person or couple if elected.

2. **Entities [§2(x)]:** A person can be a legal person too, that is entity. Entity implies the following institutions or organizations.
   - Partnership, Trust or Company;
   - Village Development Committee (VDC), Municipality or District Development Committee (DDC);
   - The Government of Nepal;

- A foreign government or a political subdivision of the foreign government or a public international organization established on the basis of a treaty; and
- A permanent establishment that is not situated in the country of individual's residence.

Partnership [§2(be)]: Partnership is an agreement between two or more than two persons investing money, goods, labor and skill or either or all of them jointly in order to advance fair trade and dividing profits and losses arising from it proportionately or otherwise between/among them. While assessing income tax only businesses with less 20 partners is considered. A partner is also characterized as an interest holder in equity of a firm. The term partnership applies to any firm irrespective of its status, whether registered or not in concerned authorities. If a partnership firm has more than 20 partners, it is considered as a company.

Company [§2(m)]: Company is an association of a number of individuals for carrying on some legitimate business. According to §2(m), company is an entity established under the prevailing company law. In addition, the following institutions are also treated as a company for tax purposes.

a. Corporate bodies established under prevailing law;
b. Any unincorporated association, committee, institution, society, or group of persons that is not a partnership or a proprietorship firm, or a trust;
c. A partnership firm with more than 20 partners, a retirement fund, a co-operative, a unit trust, or a joint venture;
d. Foreign company;
e. Any foreign institutions prescribed by the Director General of the IRD.

Trust [§2(t)]: A trust is an arrangement or agreement where a trustee holds assets but it does not include a partnership, a corporate body, or an entity.

Trustee [§2(u)]: Trustee covers an individual or a religious trust (Guthi) or a corporate body holding assets in a fiduciary manner, whether alone or jointly with other individuals or with religious trust or corporate bodies, and includes the following persons:

a Executor or administrator of estate owned by a deceased person,
b Liquidator, trustee or official receiver;

c Persons administering in a private or official capacity assets of an incapacitated individual and

d Any person who manages assets under a private foundation or other similar arrangement.

Permanent establishments [§2(bb)]: Permanent establishments are sub-standard organizational units of a company or an individual. They are places where an individual or an entity wholly or partially operates business. It also includes the following persons and places as well:

a. An agent of a taxpayer other than a general agent of independent status

b. A place where substantial equipment or machinery is used or installed

c. One or more places within a country where a person provides related services through the employee or in any other way for a period of more than 90 days within a 12 month period and relates the services of technical, professional or consulting nature; the way the services are delivered is irrelevant;

d. A place where a person is engaged in a construction, assembly, or installation project for 90 days or more whereas the term engagement also includes supervisory activities in relation to such projects.

☐ Taxpayer

The term taxpayer means any person who is either liable to pay any internal revenue tax or who is not liable volunteers to pay anyway. According to law, those persons who have not taxable income are not taxpayers.

1. In case of an individual, couple or incapacitated person*:* An individual or couple or incapacitated person may not be a taxpayer before paying tax liability.

EXAMPLE 2-11 An individual earned income Rs. 150,000 from his/her agriculture produce in an income year. If it is earned from prescribed ceiling, his income is exempt from payment of tax and the person is not called a taxpayer.

EXAMPLE 2-12 An individual having source in Nepal obtained Rs. 90,000 from different sources of income such as employment or investment, but, s/he is not called a taxpayer because at least Rs.100,000 or Rs.125,000 for individual and couple respectively is

provided for reduction from taxable income as relief for an income year.

EXAMPLE 2-13 If an individual earned taxable income after reduction of relief provided to his/her family status then it brings tax liabilities and s/he is called taxpayer.

2. In case of sole proprietorship and entities: Sole proprietorship or other entities need to take PAN before conducting business. Thus, they become taxpayers with or without tax liability. However, the sole proprietor business may or may not be registered. In both situations, the sole proprietor is entitled to pay tax.

☐ Employment

Employment includes past, present, or prospective employment. In addition, employment indicates the relation between employer and employee like that of master and servant.

☐ Investment

Investment means an act of holding or investing one or more assets but excludes: (1) the act of holding assets for personal use by the person owning asset or (2) employment or business. But, it includes act of holding non-business chargeable asset.

☐ Non-Business Chargeable Assets

Non-business chargeable asset means securities or an interest in equity as well as land and buildings but excludes the following assets:

- Business assets, depreciable assets, or trading stock;
  (a) A private residence of an individual that has been:
    - owned continuously for three years or more; and
    - lived in by an individual continuously or intermittently for a total of three years or more;

  (b) Benefit of a beneficiary in a retirement fund;
    - land and a private residence of an individual that is disposed off for less than Rs. 10,000,000/-; or
    - Non-business assets of an individual that is disposed off by any type of transfer other than sales and purchase made within three generations.

☐ Business

Business means an industry, trade, profession, or similar business transactions and includes a past, present, or prospective business. However, the term does not include employment.

☐ Withholding Agent

Withholding agent means a person who has obligation to deduct advance tax or withhold tax at the time of payment in relation to employment, investment returns, service fees, contracts or agreements.

☐ Final Withholding Payment

Final withholding payment means a payment of dividend, rent, gains, interest and payment made to a resident or non-resident person on which tax deduction has to be made.

☐ Retirement Fund

Retirement fund means any entity established and maintained solely for the purpose of accepting and investing retirement fund contributions in order to provide retirement fund payments to individuals who are beneficiaries of the entity or a dependant of such an individual.

☐ Assets

Assets means a tangible or intangible asset and includes currency, goodwill, know-how, property, an owner's interest in a foreign branch, a right to make income at present or in future, and a part of such an asset.

☐ Business Asset

Business asset means an asset to the extent to which that is used in a business. However, the term does not include trading stock or a depreciable asset of a business.

☐ Depreciable Assets

Depreciable asset means that asset when used by a business or investment for income generation is likely to lose value because of wear and tear, obsolescence, or the passage of time. But, the term does not include trading stock.

☐ Long-Term Contract

Long-term contract means such contract, the term of which exceeds 12 months and the contract is either for manufacture, installation, or construction or in relation to each, the execution of associated services or a contract with a deferred return that is not an excluded contract.

☐ Residents and Non-Residents

The Act distinguishes between resident [§2(ao)] and non-resident [§2(q)] persons. Income tax in an annual basis is normally imposed only on income of residents. A non-resident with residential income is subject to income tax in final withholding basis.

☐ Resident Person [§2(ao)]

Resident person denotes the following person with respect to an income-year:

1. If an individual is residing in Nepal: An individual residing in Nepal is divided into three categories as described below:

The normal place of abode is in Nepal: "The normal place of abode is in Nepal" is not defined in the Act. According to the DK Illustrative Oxford Dictionary, abode means "habitual residence". Similarly, according to Encarta Dictionary (2005), "abode" means "a place where somebody stays". Generally, abode requires house and property of a person in Nepal because a person's residence is there where his/her house property is located. Thus, this may justify the following two basic points.

- A person who is staying in Nepal is a resident person.
- A person is resident who may frequently travel outside Nepal but returns to Nepal without economic benefit.

EXAMPLE 2-14 A natural person operates a sole proprietorship business in Nepal. In an income year he went to London by some reasons and stayed for eight months. He returned to Nepal without any earnings. In this condition, the person becomes a resident person.

A person's presence in Nepal for 183 days or more: An individual, who stays in Nepal for 183 days or more in any period of 365 consecutive days, is another condition to be a resident of Nepal. It prescribes only for time period of the person irrespective of his/her citizenship. However, it requires a stay of the person must be without interruption or break in any period of 365 days. Moreover, the stay of 183 days in any period of 365 consecutive days may be calculated from two income years.

EXAMPLE 2-15: In an income year, a foreigner came to Nepal for the duration of 9 months. He did not involve in any economic activity during his stay in Nepal. In this event, though s/he is not considered a resident person.

EXAMPLE 2-16: In an income year, a foreigner came to Nepal to be an employee in an organization. He stayed in Nepal for 183 days including arrival and departure day and if he earned taxable income then he is considered as resident person.

EXAMPLE 2-17 A foreigner came to Nepal to be an employee in an NGO in May of an income year. He stayed in Nepal until the end of November including arrival and departure day. In this event, he is resident of Nepal since he stayed in Nepal for 210 days including two income years without any daybreak during his stay.

EXAMPLE 2-18 A Nepali citizen went to Arabian countries for job and worked for 184 days excluding departure and arrival days. If he returned Nepal with a sum of money at that moment, he is treated non-resident for that income year in Nepal.

Employee posted abroad by Nepal Government: An employee or an official of the Government of Nepal posted abroad at any time during the income year is treated as resident person.

EXAMPLE 2-19 The Government of Nepal posted a foreign secretary to the Great Britain for 2 years. However, the secretary is called resident person in Nepal even during the stay outside Nepal.

2. Partnerships: Partnership firms are always taxed as resident persons.

3. Company: Company is a resident person if it is incorporated under the laws of Nepal or has its effective management in Nepal.

4. A Trust: A trust is a resident person if it is established in Nepal, or has a resident person as a trustee, or is controlled by a resident person.

5. Permanent foreign establishments: Permanent foreign establishments are places where a person carries on a business and are subject to income tax if they belong to a non-resident person and are situated in Nepal.

6. Local bodies of the government: VDC, Municipality or DDC are also resident persons.

7. Foreign government or political sub-division of foreign government: Foreign governments or political subdivision of the foreign governments are resident persons if they are established under the laws of Nepal or has their effective management in Nepal during the year.

8. Any institution or entity established in Nepal under treaty: Any institution or entity if established under treaty is a resident person.

The Act differentiates between resident and non-resident persons. The resident persons are normally taxed on an annual basis irrespective of places of income earned while non-resident with residential income is subject to income tax in final withholding basis.

☐ Market Value of an Asset and Services

Market value of an asset and services means that normal buying and selling price for the asset or services in an ordinary course of a business amongst unrelated parties.

□ Trading Stock

Trading stock means assets owned by a person that are sold or intended to be sold in ordinary course of a business conducted by the person, work in progress on such assets, and inventories of materials to be incorporated into such assets.

□ Manager

Manager in relation to an entity means any person who participates in making senior management decisions on behalf of the entity and includes a trustee of a trust and the owner of a foreign permanent establishment.

□ Royalty [§2(ak)]

Royalty means any payment made under a lease of an intangible asset. The term royalty also includes if any payment made for the purposes of:

1. The use of, or the right to use, a copyright, patent, design, model, plan, secret formula or process, or trademark;
2. The supply of know-how;
3. The use of, or right to use, a cinematography film, video tape, sound recording, or any other like medium and the supply of information concerning industrial, commercial, or scientific experience;
4. The supply of assistance ancillary to a cinematography film, video tape, sound recording, or any other like medium and the supply of information concerning industrial, commercial, or scientific experience; or
5. A total or partial forbearance with respect to a cinematography film, video tape, sound recording, or any other like medium and the supply of information concerning industrial, commercial, or scientific experience; but the term does not include a payment of natural resource.

Not all the terms listed below are cited in the ITA 2002. However, these are frequently used in course of study.

□ Average Rate of Taxation

The average rate of taxation, however, is the total amount of income tax a person has paid as a proportion of his total income. This will generally be very different from the marginal rate.

> **EXAMPLE 2-20** Assume that there are multi-bracket for calculation of tax liability from taxable income. First bit of income is tax-free (the personal allowance), the next bit is taxed at 15% and the bit after that at the rate of 25%. In this situation, the average rate

of tax will be lower than the marginal rate if it is calculated with the total income. Thus, the percentage of payment of tax for total income is called average rate of taxation.

☐ Fair Market Value

The price an item would be sold for, assuming the buyer and a seller both have reasonable knowledge and are not under undue pressure. It is common to compare other similar investments sold near the same time as your investment to determine fair market value.

☐ Gross Income

Gross income refers different parts of income in different source. In employment income, gross income indicates total of inclusions from employment. In business and investment, it indicates the revenue minus direct costs or variable costs. Gross income is also called gross margin.

☐ Deferred income

In simple, deferred income refers income received before it is earned, such as rent received in one accounting period for use of the premises in the following period.

Earned income

Income derived from active participation in a trade or business, including wages, salary, tips, commissions, and bonuses. *This is the opposite of unearned income.*

Fixed income

Fixed income is that type of income, which is stable over a considerable period of time such as pension or annuity.

Imputed income

Imputed income means value assigned to property or income, sometimes artificially for tax purposes, as in the case of a non-interest bearing or low interest-bearing loan between persons or organizations related to each other.

☐ Net Income

Net income is that part of income, which is derived after deduction of costs of running business such as depreciation, interest, tax, other expenses etc. In other words, it is obtained after all deduction from an income. Net income may be classified as net income from investment; net income from employment and net income from business.

☐ Prepaid Expenses

A prepaid expense occurs when services or supplies are purchased but not used by the end of the accounting period, such as property taxes and insurance. For example, the term for insurance is normally one year or longer. Thus, if the term is one year, but the insurance payment date is

not at the end of the fiscal year, then a portion of the insurance cost applies to the next fiscal year. At the end of the year this portion will show on the balance sheet as a prepaid expense.

☐ Proprietorship

A proprietorship is an unincorporated business owned by one person. For tax purposes, the net income of the proprietorship is reported as self-employment income on the owner's personal income tax return. Moreover, the individual is personally liable for all debts of the business to the full extent of his or her property and business is completely control under the owner.

☐ Recurring and Non-Recurring Receipt

Recurring receipts are those which normally derived from an income stream that is expected to continue from one income year to the next while non-recurring receipts are receipts in a given income year that are not normally expected to recur in subsequent income year.

> **EXAMPLE 2-21** Receipts from business or employment are recurring receipts while most of receipts from investment are non-rrecurring receipts.

☐ Tax Liability

Tax liability is the amount, which is calculated under the prevailing tax law and that creates an obligation as debt that must be paid by the taxpayer.

☐ Revenue

In simple, revenue signifies the income of a government from all sources, used to pay for a nation's expenses. Bouvier (1856) holds that:

> The income of the government arising from taxation, duties, and the like; and, according to some correct lawyers, under the idea of revenue is also included the proceeds of the sale of stocks, lands, and other property owned by the government. By revenue is also understood the income of private individuals and corporations.

☐ Economic Zone

Economic zone also known as enterprise zone. It is an area designed to attract enterprises into areas where they would otherwise not go by offering special benefits and or special tax treatment. The benefits offered may include grants, help in meeting expenses, and loans on favorable terms and favorable tax treatment.

☐ Connected Person

Definitions of 'connected person' encompass blood relatives, lineal descendants/ancestors, members of the same partnership, and a company and its controlling shareholders. Prices paid in transactions between connected persons, which are not open market prices may often be

adjusted to market prices for tax purposes. Payments to or from a person may sometimes be treated for tax purposes as payments to or from a connected person. Actions by a person may similarly be regarded for tax purposes as actions by or on behalf of a connected person. In taxation, the connected person plays a significant role. But, the definition of connected person varies from country to country and from situation to situation.

☐ Anti-Evasion Measures

Anti-evasion measures- measures to combat tax evasion. Anti-evasion measures take the form of statutory provisions and administrative action. The tax law may provide withholding of tax (on dividends, interest, royalties, salary payments); estimation of taxable income in the absence of a (correct) declaration; obligation to supply information; reversal of the burden of proof; imposition of stiff penalties, etc. Administrative action includes critical examination of information received; spot checks by trained "fraud squads", etc.

2.4 TAX ACCOUNTING AND TIMING

Tax accounting and timing are important in taxation. These assist to formulate transparency in tax administration. In the absence of tax accounting and timing, tax authority cannot appropriately apply extensive judgment to achieve basic objectives of taxation.

2.4.1 Accounting Period

Accounting period is fundamentally important to decide the inclusions and deductions. To decide the profit or gains from ones earning we need to know what to include into and what to deduct from the taxable income that depends upon the particular time-period. Thus, time-period is needed to determine the taxable income from a particular income of a person. Generally, tax is imposed on and realized from every taxpayer for each income year. The income year is the period from the start of Shrawan of a year to the end of Ashadh of the following year. Therefore, this income year is also the time for which the taxable income needs to be computed.

The income year for the tax purposes covers the same period as the fiscal year for commercial purposes. The commercial fiscal year describes an annual accounting period of a person.

> **EXAMPLE 2-22** If a person produces his financial statements in the income year 2063/064; it denotes that financial statements of the income year 2062/063. For this purpose, his accounting period is the income year 2062/063. Thus, the person has to maintain his books

of account within the income year according to the commercial transactions done.

Thus, accounting period is an interval of time at the end of which the financial statements are prepared from the accounting data of a person.

2.4.2 Method of Tax Accounting

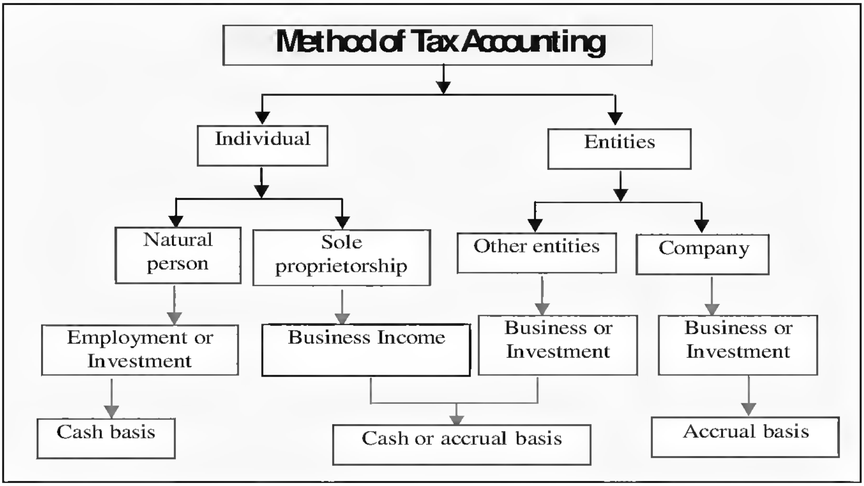
Method of accounting is a crucial element to decide the profit or gains of a person for an income year. Financial Statements can misrepresent factual information if the accounting method is misused. Therefore, tax accounting also deals with the question at what time incomes derived and costs incurred are recognized for tax purposes.

According to the Act, a person has to employ GAAP, if not well defined, the method of accounting, to produce financial statements. The GAAP are Commercial Accounting Principles (CAP), but these have to be:

- Prescribed in any law in force,
- Adopted by the Institute of Chartered Accountants of Nepal (ICAN), or
- Prescribed by the IRD based on any international standards and practice.

The Act prescribes the following methods of accounting for tax purposes:

Figure 2.3: Method of tax accounting



☐ An Individual

An individual represents natural person and sole proprietorship firm.

1. Natural person [§22(2)]: An individual, whose sources of income are employment and investment, has to account on a cash basis for his employment and investment income. The cash basis method of accounting is compulsory to such natural person.

EXAMPLE 2-23 Salary of an employee of an entity is Rs. 10,000 per month. He is fully employed during an income year. But, he received only 8 months salary from Shrawan to Falgun. The salary of Chaitra to Ashadh is remained as receivable from his employer. According to cash basis method of tax accounting, he has to submit his tax return only for 8 months salary.

2. Sole proprietorship firm [§22(4)]: An individual, who operates his business from sole proprietorship business, may choose between the cash or the accrual method of tax accounting for accounting his commercial transaction for tax purposes unless the IRD prescribes otherwise by notice in writing.

☐ **Entities**

An entity represents partnership, trust or company, government bodies and foreign government's permanent establishment. As a provision stated, the cash method of accounting is not available to company.

1. Company [§22(3)]: A company has to adopt accrual method of tax accounting to account the income from business or investment.

EXAMPLE 2-24 A limited company sold its articles of Rs. 150,000 to a proprietorship firm. The proprietorship firm did not pay this part of amount of Rs. 60,000 until the end Ashadh. Method of accounting of accrual basis is compulsory to the Company, thus, includes all amounts according to matching principles. But, the proprietorship firm may file the income tax return including or excluding Rs. 60,000 adopting accrual or cash basis of accounting respectively. But, the proprietorship firm needs consistency of the accounting method with the previous year.

2. Other entities [§22(4)]: Other entities, which receive business income or investment income, may choose between the cash or the accrual method of tax accounting for accounting their transactions for tax purposes unless the IRD prescribes otherwise by notice in writing.

2.4.3 Types of Accounting Method

There are three types of accounting method. Those are:

1. Cash basis method of accounting

2. Accrual basis method of accounting
3. Hybrid basis method of accounting

The Act has explained the former two methods of accounting and is silent on last one. However, the financial institutions, especially commercial banks and finance companies, have applied the last one as well.

☐ Cash Basis Method of Tax Accounting [§23]

Cash-basis accounting is a method of bookkeeping that records financial events based on cashflows and cash position. Under this method revenue is recognized when cash is received and expense is recognized when cash is paid. In cash-basis accounting, revenues and expenses are also called cash receipts and cash payments.

> **EXAMPLE 2.25** When you pay your rent your landlord would record an income event when you make the payment. The landlord records an expense event when he pays the rental agent their fee for your apartment. It is a cash basis of accounting.

Cash-basis accounting does not assure to pay or expect to receive money or service in the future, such as payables, receivables and prepaid expenses.

It is suitable to those individuals and organizations that do not have significant amounts of transactions or when the time lag between the initiation of the transaction and the cash flow is very short.

1. Issues with cash-basis: Cash-basis accounting fails to meet GAAP requirement because it does not follow the following two principles:

- **Revenue recognition principle**: According to this principle revenue should be recognized when it is realized including credit sales.
- **Matching principle**: According to this principle, revenue should be matched to the expense if possible. e.g. sales and cost of goods sold.

In addition, cash-basis accounting is not viable for cost accounting in manufacturing operations because expense is not associated with product cost.

2. Cash basis accounting and contract: The main principle of cash accounting consists recognition of revenue when received in cash and recognition of expense when cash is paid. However, this principle failed according to the precedence created by the Court.

EXAMPLE 2-26 A farmer was entitled to receive Rs. 10,000 payment on a contract in Jestha of an income year. The contract was not a production flexibility contract. He told in Jestha that his payment was available. At his request, he did not pay until Shrawan of the following income year. In such a case, he must include this amount in his income in the former income year because it was constructively received in Jestha of the former year.

☐ Accrual-Basis Method of Tax Accounting

Accrual-basis method of tax accounting records financial events based on events that change the networth of a person. Standard practice is to record and recognize revenues and expenses in the period in which they are incurred. Even though cash is not received or paid in a credit transaction they are recorded because they are consequential in the future income and cash flow of the person.

EXAMPLE 2-27 If a landlord would record an income event on the day its rent comes due. He records an expense event when the fee owed to the rental agent comes due for its apartment that month. It is an accrual basis method of accounting.

EXAMPLE 2-28 A Hotel registered its guest for 7 days in Ashadh 27, in an income year. The departure dates of the guest ledger shows that Shrawan 2, of the following income year. In this situation, the hotel has to adopt accrual basis of accounting method. Thus, income and costs including value added tax (VAT) for 5 days must be accounted in Ashadh of the former income year; although, the client of the company paid its bills including VAT in Shrawan 2, of the following year.

Thus, accrual-basis method of tax accounting completes the GAAP requirements.

☐ Hybrid Basis Method of Tax Accounting

Hybrid basis method of tax accounting is the mixture of cash and accrual (partly cash and partly accrual) basis method of tax accounting.

ITA 2002 has not made any provision for the hybrid method of tax accounting. However, practically financial institutions have applied the hybrid basis method of accounting according to Nepal Rastra Bank (NRB) directives.

As permitted by the directives most of banks usually account:

1. **Interest income and expenses**: Interest expense on deposits/ borrowings and interest income on the earning assets other than loans and advances account for on accrual basis.

2. **Interest income on loan:** Interest income net off rebate on loans and advances is recognized as income on cash basis.

3. **Commission income:** It is the practice of bank to account for commission on guarantees covering more than one year on earned basis. However, guarantee commission up to certain limit (Rs. 50,000 or Rs. 100,000) and other commissions accounts for on cash basis.

EXAMPLE 2-29 Interest incomes on loans and advances are recognized on cash basis and interest incomes on investments are recognized on accrual basis. While interest expenses on loan and deposits are recognized on accrual basis. This type of accounting treatment is called hybrid basis method of tax accounting.

The Act overrides others Acts. However, financial institutions, especially banks, should compulsorily use the directives of NRB.

2.4.4 Change of Accounting Method

Consistency of accounting method plays significant role in determination of profit in financial statement. The consistency concept is one of the fundamental accounting concepts that underpin the preparation of accounts. With the consistency concept, the principle applied is that there is uniformity of accounting treatment of like items within each accounting period and from one period to the next. Taxpayers can apply in writing to the IRD for a change in his basis of accounting. The IRD may then in exceptional cases allow the change if it is necessary to clearly reflect the taxpayer's income.

2.5 DIFFERENCE BETWEEN TAX ACCOUNTING AND OTHER ACCOUNTING

Commercial accounting, financial accounting and tax accounting are different sets of application of rules and are of considerable importance to their fields. Each indicates different purposes of accounting.

☐ Commercial Accounting

A commercial accounting is done as commercial transactions happened. Therefore, a commercial balance sheet and an income statement must be prepared, in which the group has legal entities in order to determine the

commercial profits and to establish what amount may be distributed as dividends.

☐ **Financial Accounting/Capital Markets Statements**

Usually, each entity listed on a stock exchange must submit its results based on Accounting Standards. The listed Company must submit the results, based on the application of the same standards by all entities entering into with "full compliance".

☐ **Tax Accounting/Tax Returns**

Each person has to submit a tax return in its residence country in order to determine its taxable profits. The taxable profits exactly may or may not be similar to the profit of financial and commercial accounting.

2.5.1 Difference Approaches and Different Purposes of Accounting

Commercial, financial and taxation rules serve their own purposes and, as a consequence, differences in the results are to be expected. Some of these purposes, objectives and principles are noted in the following table:

Table 2.2: Different approaches and purposes of accounting

Legal basis	Commercial law	Capital market law [FARS])	Taxation law
Purpose of the rules	Determination of commercial results of a legal entity	Determination of financial performance of an entity (domestic & foreign entities)	1. Determination of taxable profits 2. Single entity approach or consolidated profits of (domestic) group
Objectives	1. Protection of creditors 2. Protection of shareholders 3. Measure distributable profits	1. Information/protection of investor/stakeholders 2. Transparency 3. Comparability	1. Establish tax liability 2. Protection of state revenue 3. Neutrality 4. Equity 5. Avoidance of double taxation 6. Non-fiscal objectives such as incentives or disincentives
Valuation principles	1. Prudence 2. Historical cost 3. Separate entity approach	1. Fair presentation 2. Substance over form 3. Economic view 4. Recognition of value changes	1. Realization 2. Prudence 3. Annual liability (loss carryovers, depreciations, deferrals) 4. Recognition of foreign tax 5. Profits smoothing

Enterprises that are listed on stock exchanges must follow Financial Accounting and Reporting Standard (FARS) rules aimed at providing investors with a true and fair view of the financial position of the enterprise. These rules increase transparency and worldwide comparability of the results of an enterprise or a group. These rules are quickly shifting away from traditional legal concepts applied in commercial and fiscal laws. They are increasingly based on a fair presentation approach. The results shown for financial purposes may differ considerably from the profits shown in the books of single enterprises or in the tax returns.

2.6 BAD DEBTS AND ITS RECOVERY

Bad debts expenses, recovery, disclaimer, write-off, or waiver are the general events of live transactions. These cases normally occur in business, investment and employment in an income year. Thus, one act, which exists, its significance has to entail essential provisions to these events. Considering these fact, §25 of the Act, has mentioned some prominent provisions about the bad debts. However, this has not mentioned the definition of bad debts.

☐ Definition of Bad Debts

"In accounting and finance, bad debt is the portion of receivables that can no longer be collected, typically from accounts receivables or loans. Bad debt in accounting is considered an expense" (Anonymous, 2002). Thus, in short, bad debt is uncollectible receivable of sales, which binds to write off as an expense.

☐ Principles of Accounting Practice (PAP):

According to PAP, bad debt expense has to cover the matching principle of accounting. Revenues and expenses should be recorded in that period in which they are incurred. When a sale is made on account, revenue is recorded along with account receivable. Because there is an inherent risk that clients might default on payment, accounts receivable have to be recorded at net realizable value. The portion of the account receivable that is estimated to be uncollectible is set aside in a contra-asset account called allowance for doubtful accounts. At the end of each accountng cycle, adjusting entries are made to charge as expense to uncollectible receivable. The actual amount of uncollectible receivable is written off as an expense from allowance for doubtful accounts to the account called bad debt expense.

☐ Bad Debt Expenses

Bad debts arising from a business, investment and employment can be deducted for an income year when they become worthless. However, a non-business chargeable debt, which becomes worthless, is considered a capital bad debt and treated accordingly.

EXAMPLE 2-30 A Limited could not recover its receivable Rs. 15,000 from a business during the first year. The Limited also tried all usual method to recover receivable amounts in the following (second) income year but the amount remained irrecoverable. In this situation, the business debt can consider as bad debt and value of debt can write off.

EXAMPLE 2-31 A person did not recover debt amount Rs 55,000 of house and land sale during the year. It was brought forward from previous year. The person used all usual methods to recover the amounts but it remained irrecoverable. In this event, the irrecoverable amount is taken as capital bad debts and it can be written off only by net gains from non-business taxable assets, if any.

☐ Requirements to Write-off Bad Debts

According to §25(2), a person's claim is considered as bad debt when he disclaims the right to an amount or write-off a claim while satisfying following conditions:

1. If a debt claim of a bank or a financial institution becomes a bad debt as determined in accordance with the prescribed standards issued by NRB, and
2. Apart from conditions referred above, in all other cases after the person has taken all appropriate steps in pursuing payment and believes that the entitlement or debt claim is not possible to recover.

☐ Bad Debt Recovery

A bad debt recovery denotes recovery of a previous bad debt whether remitted or not. The remitted bad debts are those, which were reduced from income as an expense. Similarly, not remitted bad debts are those, which were not reduced from income as an expense.

EXAMPLE 2-32 A Company identified doubtful debtors "X" and "Y" in the first year. The Company declared them as bad debtors in the later year after the end of usual method of collection. Therefore, both bad debts of "X" and "Y" were written off. But, the amount of "X" did not satisfy the requirement of bad

debts. Thus, the amount of bad debts of "Y" can be remitted but not of "X".

☐ Treatment of Recovery

In case of recovery, it offers two options to settle bad debts: - first recovered amount has to be included if it is derived after remission and second has to be excluded if it is derived without remission.

EXAMPLE 2-33 An entity recovered its two bad debts among various bad debts. Those were from "P" and "Q". Between these two, the amount of "P" was remitted while "Q" was not remitted in earlier income year. In this event, that entity has to include only the first one in tax return.

Especially, bad debts are crucial factors in business. Thus, businesspersons should adopt some effective measures to manage bad debts.

2.7 METHOD OF DETERMINING AVERAGE OF LONG-TERM CONTRACT

A contract is any legally enforceable promise or set of promises made by one party to another. When such contract exceeds the duration of 12 months and the contract is either a contract for manufacture, installation, or construction, or, in relation to each, the performance of related services; or a contract with a deferred return that is not an excluded contract are called long-term contracts. The long-term contract includes other provision too.

☐ Contracts with a Deferred Return

Any contract of a person which does not present the details regarding estimated gain and estimated loss during every six-month period from the commencement of the contract as prescribed by the IRD is known as contract with a differed return.

☐ Excluded Contract

Any contract created by reason of an interest in an entity or by obtaining a membership in a retirement fund or any contract of investment insurance is known as excluded contract. These contracts do not fall under the long-term contract.

EXAMPLE 2.34 A natural person insured him by life insurance accepting some terms and conditions prescribed by the insurer. It is a type of contract, which completes the requirements of proposal and acceptance. In addition, it is longer than 12 months duration.

But, such type of contract is not long-term contract because it is an excluded contract.

☐ Provisions Regarding Long-Term Contract

There are some other provisions regarding long-term contract, which are as follows:

1. Cumulative inclusions: Cumulative inclusions under a contract of a person at a particular time means amounts under the contract required to be included at the time or a previous time in calculating the person's income from an employment, business, or investment, disregarding the calculations of a normal income year.

EXAMPLE 2-35 A person introduced into a contract Rs. 64,000,000. The duration of the contract was four years and completion portion of the contract is 60 percent up to end of the second year. Thus, cumulative inclusion of the contract up to end of second year is to Rs. 38,400,000.

2. Cumulative deductions: Cumulative deductions under a contract of a person at a particular time means amounts under the contract that may be deducted at the time or a previous time in calculating the person's income from a business or investment, disregarding the calculations of a normal income year.

EXAMPLE 2-36 A project introduced into a contract of Rs. 64,000,000 estimating total cost Rs. 48,000,000. The duration of the contract was four years and the completion portion of the contract is 60 percent but amount of expenses made up to end of the second year including raw material in store is Rs. 40,000,000. In this position, the cumulative deduction of the contract up to end of the second year is to Rs. 28,800,000.

3. Percentage of contract completed: Percentage of contract completed with a deferred return, cumulative inclusions, cumulative deductions, and excluded contract are determined at a particular time as below.

In case of a contract for manufacture, installation, or construction or in relation to each, the performance of related services is determined by comparing cumulative deductions under the contract with estimated cumulative deductions at the time the contract is to end.

Thus,

Calculation of percentage of contract completed:		Amount
Equals	Cumulative deductions up to this time	×
Divide	Total of estimated cost of the contract	×
Multiply	By hundred	100
Completion percent		×

EXAMPLE 2-37 A project made cumulative deductions up to the end of second year Rs. 28,400,000 where total estimated cost of the contract is Rs. 48,000,000. Thus, the completion portion of the contract is 60 percent.

EXAMPLE 2-38 Contract sales recognized under the percentage of completion method were approximately Rs 6.7 billion in 2005 (Rs. 6.7 billion in 2004). Payments received in advance of contract revenues were Rs 146 million at the end of 2005 (Rs. 97 million in 2004). Thus, contract revenues recorded prior to billings were not significant.

If a contract to the extent to which is not covered long-term contract that is determined in the manner prescribed by the IRD. The provisions concerning long-term contract cannot be applied to a person for an income-year unless the person is obligatory to file an estimate of tax owed for the year under submission of estimated tax return file.

REVIEW QUESTIONS AND CASES

1. Define "person". Illustrate all classifications of persons.
2. Write short notes:
   - Resident and non-resident
   - Income year, assessment year and previous year
   - Withholding amount
   - Jeopardy assessment
3. What is an asset? Explain with example depreciable business assets.
4. What is permanent foreign establishment? Illustrate an example of permanent foreign establishment in Nepal.
5. Define proprietorship, partnership and company? Are all entities are taxpayers?"
6. Assessable income is quite different from net income. How?
7. Describe assessable income, taxable income and tax base comparing between an individual and entity.
8. Define recurring and non-recurring receipt in the case of an individual.

9. Differentiate between withholding payment and final withholding payment.
10. "Royalty is a return of intangible assets". Do you agree with this statement? If not why?
11. What are the dissimilarities between cash basis accounting and accrual basis accounting?
12. If you adopted cash basis method of accounting both income and expense may be postponed. Do you consider it is also a tool for tax planning?
13. Differentiate the terms with examples: timing of accounting and reporting of accounting.

Chapter 3

Quantification, Allocation and Characterization of Amounts

3.1 QUANTIFICATION OF AMOUNTS

Quantifications are new provisions. Before enforcement of ITA 2002, all the preceding taxation laws of Nepal were implied about kind income and its quantification. As a result, taxpayers were benefited by fringe or kind other than cash payment. It means that benefit received in kind or service was not taxed. In short, provision of quantification signifies amount of benefit received by the person other than cash. Thus, in this Act, the benefits received by taxpayers are quantified equal to the following amounts.

☐ Transferred of Assets

Transfer of assets is the act by which the owner of a thing delivers it to another person, with the intent of passing the rights, which he has in it to the latter. If a person makes a transaction to another by transferring an asset, the amount equivalent to market value of the transferred asset is taken into account as paid.

EXAMPLE 3-1 "A" transferred a piece of land to "B" without receiving any consideration. At the time market price of the land was Rs. 150,000. According to law, the amount of payment of "A" and receipt of "B" is to be valued for Rs. 150,000.

EXAMPLE 3-2 A Carpet factory provides to its office manager 10 pieces of carpet one square meter each in lieu of overtime work. At the time market price of carpet per square meter is Rs 1,700. In this context, value of the pieces is to quantify Rs. 17,000 from disposal of trading stock (income) and overtime pay (expenses) to the Carpet factory and same amount as overtime salary to the manager.

☐ Facilities

Income Tax Rules 2002 (ITR, 2002) quantifies the following facilities in accordance to the following amounts.

1. Vehicle facilities: The use or availability for use of a motor vehicle to a beneficiary including an employee or a worker wholly or partly for private purposes is to quantify as following for an income year.

But, the ITR 2002 has not defined the terms "wholly" or "partly for private purposes".

In simple, to go to place of employment or office or working station from his place of resident is his private work of an employee because the employee never get employment in his resident. The "partly or wholly for private purposes" can be clarified by the following two circumstances.

EXAMPLE 3-3 An employer has provided a vehicle to his employee to go to place of employment and back to dwelling including other personal uses of the employee. However, the use of vehicle is compulsory for business purposes too. Therefore, it is used in business for office hour is "the use or availability for use of a vehicle partly for private purposes".

EXAMPLE 3-4 An employer has provided a vehicle to his employee to go to place of employment and back to dwelling

including other personal uses of the employee only, is “the use of availability for use of a vehicle wholly for private purposes”.

- Where the person is an employee or worker or a person who is remunerated by the payer on a monthly basis, 0.5 percent of the salary of the person is to be quantified as amount received.

EXAMPLE 3-5 A worker of an entity is remunerated by salary of Rs. 25,000 and intelligence allowance of Rs. 2,000 per month. He is also provided a Toyota car for official as well as private propose. In this case, the vehicle facility of the employee has to be quantified as 0.5 percent of his salary as received:

1	Salary (Rs. 25,000×12)	300,000
2	Intelligence allowance (Rs. 2,000×12)	24,000
3	Fringe benefit for vehicle facility [As per §24(1b1)] – [0.5% of Rs. 300,000]	1,500
Assessable income from employment		325,500

Thus, Rs. 1,500 is to include in his income from employment as amount received in respect of fringe benefit for vehicle facility.

- In any other case which is not covered by the terms and condition of an employee or worker or a person and who is not remunerated by the payer on a monthly basis that has to quantify one percent of the prevailing market value of the motor vehicle per annum.

EXAMPLE 3-6 A president of the Board of Director of a Company is provided a Santro Car. But, the president is neither employee nor gets monthly remuneration from the Company. In this context, if market price of the motor vehicle (Santro car) is Rs. 1,200,000 then he has to calculate fringe benefit for vehicle facility as:

Market price of the motor vehicle (Santro car)	1,200,000
Multiplier prescribed by the Act	1%
Fringe benefit for use of vehicle	12,000

Thus, the president of the Board of Director of the Company has to include Rs. 12,000 in his income.

EXAMPLE 3-7 A member of the Parliament (MP) has facilitated with a Benz Car for seven month. But, an NGO owns the Car. In this position, amount of benefit is to calculate according to Arms Length Principles (ALP).

Fair market rent of Benz car for a month	12,000
Duration of the use of vehicle in month (multiplier)	7
Fringe benefit for use of vehicle	84,000

Thus, both persons—the MP and the NGO—have to include Rs. 4,000 in their taxable income.

2. House facility: The use or availability for use of a house to a beneficiary including an employee or a worker for private purposes is to quantify as following for an income year.

- Where a person is an employee or worker or a person who is remunerated by the payer on a monthly basis, two percent of the salary of the person is to quantify as amount received.

EXAMPLE 3-8 An accountant of an organization gets monthly salary Rs. 50,000 including overtime pay Rs. 5,000. He is provided a well-furnished house facility owned by the employer. In this context, the person's fringe benefit for the house facility has to quantify two percent of the salary as calculated below:

1	Salary (Rs. 45,000×12)	540,000
2	Overtime pay (Rs. 5,000×12)	60,000
3	Fringe benefit for house facility [Two percent of Rs. 540,000 =Rs. 10,800]	10,800
Assessable income from employment		610,800

Therefore, the employee of that organization should include this fringe benefit of house facility Rs. 10,800 in his employment income.

- Where a payer rents the house and makes available to a person who is not covered by the terms and conditions of an employee or worker or a person who is not remunerated by the payer on a monthly basis, 25 percent of the rent paid is to quantify as amount received.

EXAMPLE 3-9 A non-paying Counselor of a Limited is provided house facility. To provide house facility, the limited pays as rent Rs. 40,000. In this context, the counselor has to include Rs. 10,000 (25% of the Rs. 40,000) as amount of fringe benefit from the use of house facility.

- Where the payer does not pay house rent directly but makes the house available to the person who is not covered by the terms and conditions of an employee or worker or a person who is not remunerated by the payer on a monthly basis, 25

percent of the prevailing market value of the house rent per annum is to be quantified as amount received.

EXAMPLE 3-10 A Board Member of a Company is provided house facility on a building. The prevailing market value of the building rent is Rs. 150,000 per annum and the company on monthly basis does not remunerate him. In such case, the Board Member has to include Rs. 37,500 (25% of the Rs. 150,000) in his income for that fringe benefit from house facility.

3. Other facilities including fringe benefit: For payments consisting of the provision of the following facilities, the amount of the expenses incurred by the payer in making the provision as reduced by any contribution made by the payee towards the provision;

- **Amount of the domestic assistant:** The amount of domestic assistants: housekeeper, chauffeur [a person employed to and attends motor vehicle for another], gardener or other individual paid by the employer has to include in income of the employee after deducting contribution of the employee upon such assistants.

EXAMPLE 3-11 A General Manager (G.M.) of a Bank is facilitated by two domestic helpers: kitchen boy and chauffeur. Both are employed to operate and attend for the G.M. but are remunerated by the bank Rs. 5,000 each per month. The bank deducts Rs. 2,000 per month for this facility from the salary of the G.M. In this context, fringe benefit for kitchen boy and chauffeur is calculated as given below to quantify the benefit acquired by the GM.:

Equal	Salary of kitchen boy and chauffeur paid by employer (Rs. 5,000 × 2 × 12 months)	120,000
Less	Amount deduction from GM's salary against those Kitchen boy and Chauffeur (Rs. 2,000 ×12)	24,000
Fringe benefit from kitchen boy and chauffeur		96,000

Thus, GM has to include Rs. 96,000 in his income from employment as benefit acquired from employer.

- **Amount of the meal, refreshment, or entertainment:** If some employee are facilitated by any meal, refreshment, or entertainment that has to be quantified by as paid by the payer, however, if the employer has provided meals or refreshments in the work premises to all his employees on

similar terms no value for this benefit needs to be included in the employee's income.

EXAMPLE 3-12 An entity provides lunch for each working day to all employees in equal basis in his business premises. However, a marketing manager is in excess benefit by extra dinner each working day and employer pays Rs. 1,200 per month. In this context, the marketing manager has to calculate his extra facility as given below:

Amount expended for marketing manager per month	1,200
Duration of the fringe benefit received	12
Fringe benefit for meal facility	14,400

According to the calculation the marketing manager has to include this fringe benefit for meal facility in his employment income.

- **Amount of tariffs etc.:** If the payer pays any tariffs of the utilities: drinking water, electricity, telephone and others in respect of the payee's place of residence then these amounts of payments have to include in the income of beneficiaries.

EXAMPLE 3-13 A Company provides utilities facilities: tariffs of telephone and electricity to its employee. The total cost of such tariffs during an income year is Rs. 16,000 and it is if paid by the employer; the employee has to include this sum of amount in his employment income.

☐ Soft Loan

If any person is benefited by the loan and that is lower than interest to be paid as per the standard interest rate, the amount has to include to the extent it is lower. For example, if an employee received a loan from his employer and is granted interest rates that are lower than market rate, the amount by which interests payable is lower than interest at the market rate has to include into the employee's income as a kind payment [§27(d)].

EXAMPLE 3-14 A Company provided home loan to its employee Rs. 100,000 with an annual interest rate of 10 percent. But, the interest rate of similar type of loan in prevailing market is 15 percent. In this condition, difference of actual interest and interest as per market rate in the case of soft loan is calculated as:

Interest rate in fair market	15%
Interest rate charged by employer	10%
Excess of fair market rate over employer interest rate	5%

Multiplied by amount of loan received	100,000
Difference of actual interest and interest as per market rate in case of a soft loan [§25(1)(d)]	5,000

Therefore, difference of actual interest and interest as per market rate in the case of a soft loan as calculated above Rs. 5,000 has to be included in the company's as well as employee's income.

EXAMPLE 3-15 In the beginning of an income year, an employee took loan Rs. 50,000 from his employer. The term of loan was repayment of the loan, plus 5 percent additional amount at the end of income year. In the starting of the income year, prevailing market interest rate was 10 percent for similar type of loan. The difference between the prevailing market interest rate and the rate of loan is 5 percent. Thus, in this condition the difference of interest is calculated as given below:

Interest rate in the prevailing market	10%
Interest rate charged by employer	5%
Excess of prevailing market rate over employer interest rate	5%
Multiplied by amount of loan received	50,000
Difference of actual interest and interest as per market rate in case of a soft loan [§25(1)(d)]	2,500

Therefore, in this situation the employer and employee both have to include Rs. 2,500 in their taxable income as difference of actual interest and interest as per market rate in case of a soft loan [§25(1)(d)].

☐ Conversion into the Nepalese Rupees

All amounts used in calculating the taxpayer's income require to be quantified in Nepali Rupees. The existed amount of different currency must convert into Nepali Rupees at the time the amount is recognized for tax purposes and at the standard exchange rate at that time [§28].

EXAMPLE 3-16 A tourist guide was awarded by his employer 100 US dollars for his excellent guide skill. In this case, the foreign currency received by the guide has to quantify as:

Foreign currency (US $) received by employer	100
Market rate for the day Rs.	75
Amount decided in Nepali rupees for tax purposes	7,500

Thus, the guide has to include Rs. 7,500 this gift income in his employment income.

EXAMPLE 3-17 A travel agency sold a tour package of 4,000 US dollars on a day at that day the exchange rate was Rs. 75 per dollar. In next day the exchange rate reduced to Rs. 72 per dollar on which day it deposited at bank. In this circumstance, the agency has to invoice of 4,000 dollars at the rate of Rs. 75 due to its time of package sold.

3.2 ALLOCATION OF AMOUNTS

Allocation is the division of elements or amounts between or among the persons. Thus, in taxation allocation refers the division of taxable income and its expenses between or among the persons.

□ Indirect Payments [§29]

When a person takes indirect benefits from the payers or an associate of the payer or directs the payee of a payment, the IRD may, by notice in writing, treat the person as the payee of the payment [§29]. In other words, in case a taxpayer indirectly benefits from a payment or directs who is to be the recipient of a payment and the payer intends to benefit this taxpayer the IRD has the right to reallocate the payment and treat the taxpayer as the recipient of the payment notifying this event to the taxpayer.

EXAMPLE 3-18 Tad and Pole are intimate friends. Pole fell sick and asked for his help. Tad took an advance from his employer and the advance money gave to Pole. Pole got well from his sickness and gave the bill of expenses of treatment to Tad. Tad cleared his advance from the bill of expenses of treatment. In this circumstance, the amount of treatment is to be considered as income from employment for Tad.

EXAMPLE 3-19 A lady acquired a motorbike free of cost. But, a gentleman paid the cost of the motorbike. Due to benefit, the cost of the motorbike is to include in the income of lady.

EXAMPLE 3-20 A lecturer lectures in a College and his son study at the same college. The College provides salary to the lecturer Rs. 8,000 per month considering fee waiver to his son. The monthly fee of his son is Rs. 1,000; the salary of the lecturer is to account Rs. 9,000 by considering method of indirect payment.

☐ Jointly Owned Investment [§30]

For the purposes of calculating a person's income from an investment that is jointly owned with another person, the amounts to be included and deducted in that calculation are apportioned among the joint owners in proportion to their respective interests in the investment.

EXAMPLE 3-21 Assume that Sorrow and Rejoice have made joint investment on share of Rs. 100,000 constituting their share 60 and 40 percent respectively. The return on share is Rs. 25,000 and collection costs for this amount is Rs. 1,000. Under this circumstance, their proportion of allocation is to 60 and 40 percent for receiving the income and bearing the costs.

☐ Transfer Pricing and Other Arrangements between Associates [§ 33]

A transfer pricing and other arrangement between associates signifies any arrangement of transactions between the associates that is agreed ignoring arms length concept. Important in this regard is the arm's length concept. Particularly in dealings between related parties, transactions may be tested by checking to whether the taxpayers acted in an arm's length manner. The question to be raised is: Would unrelated parties have handled the transaction in the same way? When such dealing between associates if effects the tax amount; the IRD reserves the power to re-allocate amounts to be included or deducted in calculating income from employment, investment or business, if taxpayers who are associates have made transfer pricing or other arrangements or entered into agreements that would not have been made or entered in between taxpayers that are unrelated.

EXAMPLE 3-22 A Kid Company is associated person of Dad Company of India. Kid imports raw material from Dad paying by 10 percent higher price ignoring arm's length dealing. The same goods can avail by 10 percent cheap price if purchased with third party or other market places. In this circumstance, Kid needs adjustment of import price as given below:

Total cost of import of raw materials	110%
Price of the other market place	100%
Reduction for adjustment (in percent)	9.09%

Thus, Kid has to reduce cost of import by 9.09 percent from his total import price.

EXAMPLE 3-23 Assume that Elder Company controls 51 percent share of Young Company. Elder and Yong are established in

Bangladesh and Nepal respectively. Young produces cosmetic goods in Nepal; however, it imports raw material from Elder and exports its produces to Elder. Young ignores arm's length dealing in buying and selling. If Young dealt to other third party as arm's length dealing it increases its expenses by 5 percent and gains sales by 10. In this position, transfer pricing of Young has to be treated as per arm's length dealing.

EXAMPLE 3-24 A sole shareholder of Own Company leases its property to Self Company for a yearly rent Rs. 60,000. To test whether Self Company should be allowed a rent deduction for this amount, the IRD and the courts will apply the arm's length concept. Would Own Company have paid Rs. 60,000 a year in rent if it had leased the same property from an unrelated party (rather than from sole shareholder)? Suppose it is determined that an unrelated third party would have paid an annual rent for the property of only Rs. 50,000. Under this condition, Own Company will be allowed a deduction Rs. 50,000 only. The other Rs. 10,000 that was paid for the use of the property represents a nondeductible dividend. Accordingly, the sole shareholder will be treated as having received rent income Rs. 50,000 and dividend income Rs. 10,000.

If the arrangements or agreements are not conducted at arm's length or if the reason for the arrangements or agreements lies in the relationship of the taxpayers the re-allocation is targeted at reflecting the taxable income or tax payable as it would have arisen for the associated taxpayers if they would have entered into arrangements or agreements like amongst unrelated parties.

☐ Income Splitting [§34]

Centre for tax policy and administration (n.d.) defined an income splitting as:

> A number of arrangements, the essential feature of which is that income, which would have been taxed at a higher rate in the hands of the person who derived it, is taxed in the hands of another person at a lower rate.

Thus, income split denotes division of income into potential parts to reduce tax liability. Amount of tax liability depends upon the tax base and tax rate. It is simple to adjust the taxable incomes among the persons making understanding between each other if they have different level of incomes with different brackets. Thus, person who falls under marginal tax burden can split his income and can grab benefit by undue influence, which gradually harms to the government.

EXAMPLE 3-25 A husband and his spouse both works in an NGO. Assume that they are individual person for the tax purposes. In an income year husband earns taxable income after individual exemption Rs. 175,000 where his spouse earns such taxable income only Rs. 10,000. According to this situation, their total tax liability becomes Rs. 37,750 constituting Rs. 36,250 and Rs. 1,500 to husband and wife respectively.

Considering this fact of tax liability husband requested to NGO to reduce his income by Rs. 65,000 and adding same amount to his spouse's income and his employer did so. Thus, the total tax liability turned and reduced to Rs. 31,250 constituting Rs. 20,000 and Rs. 11,250 to husband and spouse respectively. Thus, this type of split of income reduces tax liability of the couple by Rs. 6,500.

If a person attempts to split income with another person and this income splitting is probable by reason of a tax reduction, the IRD is given the right to adjust amounts to be included or deducted in calculating the income of each person. According to provision of §34(1) the duty of the IRD is to prevent any reduction in tax payable as a result of the splitting of income.

3.3 CHARACTERIZATION OF AMOUNTS

Characterization is the classification, quantification and interpretation of laws applicable to a case, if it conflicts to meaning of one. Characterization can involve developing a variety of aspects of a character: appearance, age, gender, educational level, vocation or occupation, financial status, marital status, hobbies, religious beliefs, ambitions, motivations, etc. Often these can be shown through the actions and language of the character, rather than by telling the reader directly. Thus, to avoid the doubts and justify the situation, ITA 2002 has provided some characterization of amounts under §31, §32 and §35.

☐ Compensation Payments [§31]

Where a person or an associate of a person derives a compensation amount, including a payment under insurance that compensates for income from or an amount to be included in calculating the person's income which the person expects or expected to derive at the time the compensation amount is derived, it has to be included in calculating the income from the employment, business, or investment, as the case requires.

EXAMPLE 3-26 An employee gets salary Rs. 110,000 per annum. He is insured by life insurance policy including accident. In a year, he fell down from his motorbike and received compensation Rs.

15,000 from Insurance Company. In this context, the amount of compensation has to be included in investment income.

EXAMPLE 3-27 An employee has been agreeing salary Rs. 10,000 per month from mutual understanding for a year. But, three month later his employer reduced his salary Rs. 8,000 for the future. The employee sued at the Labor Court for full salary. The court decided to restate his salary Rs. 10,000 in addition to Rs. 5,000 compensation. In this condition, the compensation Rs. 5,000 regards to income from employment.

EXAMPLE 3-28 An employee works in an NGO and operates business too. In a year, business contract breached by party and received compensation Rs. 30,000 against breach of contract. In the same year, he also received compensation Rs. 7,000 from his employer. In this movement, the amounts of compensations have to be characterized as for business income Rs. 30,000 and for employment income Rs. 7,000.

☐ Amount of Gifts

Generally, value received as a gift by a person is to be included in taxable income. However, the value may be subject to tax on business, investment and employment income. Thus, the value of gift of the person should be characterized in the respective heads as given below:

1	Employment income	If the gift received by a person in respect of the employment from employer.
2	Investment income	If the gift received by a person in respect of the investment.
3	Business income	If the gift received by a person in respect of the business course.

☐ Annuity, Installment Sale, or Finance Lease Payments

Installments payments on annuity, installment sale, or a finance lease are critical amounts. The payments under an annuity, an installment sale, or a finance lease are re-characterized as interest and a repayment of capital under a debt claim. Generally annuities, installment sales, and finance leases are economically equally synchronized. So that, it is required to be ensured that these substitutable forms of financing are treated parallel.

All payments under an annuity, an installment sale, or a finance lease must be aggregated. The total is then divided into a capital portion and an interest portion. The capital portion is treated as a repayment of capital and the interest portion is dealt with as interest paid or to be paid.

EXAMPLE 3-29 Imagine that, a Company operates business of housing with two selling options: cash sales and installment sales. There are 10 houses under the ownership. Each houses costs Rs. 1,100,000 if they purchased on cash. Under the installment basis, they cost Rs. 1,200,000 each for 12 installments within a year. According to scheme of the Company, a person if purchased a home on installment basis; the aggregation and segregation of amounts for the Company is calculated for principal and interest Rs. 1,100,000 and Rs. 100,000 respectively.

☐ Segregation of Principal and Interest under Blended Loan

A blended loan means a loan under which payments by the borrower represent in part a payment of interest and a part a repayment of capital and the interest part is calculated on capital outstanding at the time of each payment, and the rate of interest is uniform over the term of the loan. If the taxpayer cannot provide such a list, he must treat the interest and capital portion of the annuity, installment sale, or finance lease as a blended loan with the interest compounded six monthly.

EXAMPLE 3-30 A client agreed a blended loan for an annuity, installment sale, or a finance lease from a Finance Company. The company has charged five installments in each year Rs. 181,700. In this situation, the client and the finance company has to calculate their principal and interest according to the following table to determine the taxable income.

Segregation of principal and interest of the blended loan

Year	Opening balance	Total payments	Principal payment	Interest due	Interest payment	Interest capitalized	Closing principal
1	600,000			30,000		30,000	630,000
	630,000	181,700	120,200	31,500	61,500		509,800
2	517,600			25,880		25,880	543,480
	543,480	181,700	128,646	27,174	53,054		414,834
3	414,834			20,742		19,773	434,607
	434,607	181,700	139,228	21,730	42,472		295,379
4	295,379			14,769		14,093	309,472
	309,472	181,700	151,457	15,474	30,243		158,015
5	158,015			7,901		7,548	165,563
	165,563	181,700	165,562	8,237	16,138		0
		908,500	705,094		203,406		

According to the Act, finance leases are treated as sales. A finance lease with respect to leasing of an asset means a lease where it fulfill the following conditions:

1. The lease agreement at the end of the lease term provides for the transfer of ownership or comprises the option for the lessee to purchase the asset for a fixed or presupposed price,
2. The estimated market value at the end of the lease term is less than 20% of the market value at the beginning of the lease, or
3. The asset is custom made for the lessee and at the end of the lease will not be of practical use to anyone other than the lessee and
4. The lease term exceeds 75% or the useful life of the asset.

☐ **General Anti-Avoidance Rule (GAAR) [§35]**

As a GAAR to correct and re-characterize arrangement targeted at minimizing the taxable income or payable tax the IRD is empowered to re-typify arrangements, of which one of the main purpose is to avoid or reduce the liability of tax. Other arrangements, which the IRD may correct, are those that do not have a substantial economic effect or appear in a legal form that does not reflect the economic substance of the arrangement.

REVIEW QUESTIONS AND CASES

1 What are the incomes that are chargeable to income tax under the quantification? Discuss briefly.

2 What is quantification? What are the provisions of the income tax Act on the taxability and evaluation of perquisites?

3 Explain the meaning of terms 'quantification, allocation and characterization.

4 Mr. Bansal is a lecturer in Tribhuvan University. He joined on Poush 3, 2054 in the pay scale Rs. 12,500-200(10) Rs. 14,500 -300(10) Rs. 17,500. The salary is payable on the first day of every month and the date of his increment is after completion of the one year. The other details of his income for the previous year are given below:

1. Cost of living adjustment allowance Rs. 1,200 per month.
2. Academic allowance Rs. 600 per month
3. The other facilities were:
   (a) Vehicle facilities excluding private facility.
   (b) House facilities for private purposes.

Required:

Total amount of fringe benefit [5]

5 Madhu Shakhah, a member of the Parliament received the following benefit for the previous year.

1. Emoluments including allowance Rs. 326,000 per annum
2. Secretary allowance Rs. 65,000 per annum
3. Tea hosting allowance for party members Rs. 5,000 per month
4. Newspaper and magazine allowance Rs. 1,000 per month.
5. Meeting allowance from the State Provision Board Rs. 5,000 per month.
6. The other benefits were:
   (a) Vehicle facilities (one is provided by the government and other is received by Nepal electricity).
   (b) House facility provided by the Government.

Required:

Total amount of fringe benefit [5]

6 Two companies, X Co. and Y Co. employ Tshiring: The following data is available in respect of expenditure incurred by the two companies on giving salary/allowances and providing different perquisites per annum for the relevant income year:

Time of engagement	X Co. 7 AM to 1 PM	Y. Co. 2 PM to 9 PM
Basic salary	120,000	160,000
Education allowance	18,000	24,000
Commission	20,000	15,000
Bonus	16,000	No
Free car provided for personal purposes	Yes	Yes
Free gas and electricity provided	4,000	10,000
Rent free furnished house	Yes	No
Tiffin at business premises in similar basis	Yes	No.
Outdoor Tiffin (equivalent Rs. 1,000 p/m)	No	Yes
Domestic helpers (a Gardener)	No	Yes

The Gardener received salary Rs. 2,500 per month from Y Co.

Required:

Total amount of fringe benefit [5]

Chapter 4

Exempt Amounts and Other Concessions

Income exempt from payment of tax is an ordinary course of movement. At some point, income exemption from payment of tax is recommendatory rather than imposition of tax on income. Tax should not be imposed in order to exempt tax from income for identical purposes. Tax exemption reduces administrative expenses to some extent. Similarly, it saves time, manpower, and unnecessary administrative activities for the government. Therefore, most of the governments adopt tax exemption from income considering the international laws, welfare functions, social security and approaches to protect for domestic industries. Wikipedia (2005) mentions:

> A tax exemption is an exemption to the tax law of a state or nation in which part of the taxes that would normally be collected from an individual or an organization is instead forgone.

Therefore, tax exemption is the state of free from an obligation of payment of tax. According to this provision, the government permits to earn income without paying tax.

Tax holiday is quite different to tax exemption. It is a fiscal policy measure often found in developing countries. IBFD (2006) cites:

> A tax holiday offers a period of exemption from income tax for new industries in order to develop or diversify domestic industries. The exemption is usually given for a term of years to 'pioneer' or 'infant' industries.

Normally a tax exemption is provided to an individual or organization, which falls within a protected class of some kind. Tax exemptions are usually meant to either reduce the tax burden from a particular segment of society in the interests of fairness or to promote some type of economic activity through reducing the tax burden on those organizations or individuals who are involved in that activity. But, a tax holiday refers a period of no taxation or a period during which a company is exempt from payment of tax.

4.1 EXEMPT ORGANIZATIONS

In general practice, tax exempt organizations include public charities, private foundations, private operating foundations, trusts, hospitals and hospital and research centers, a human society, environmental groups, research institutions, non-profit telecommunications media and trade associations. Current tax law has recognized tax-exempt organizations. To obtain a tax-exempt status, nonprofit organizations must file documents with the IRD that prove them to be operated for certain charitable purposes specified by law. Donations and contributions derived by a tax-exempt organization are tax-free. An organization, whose income is exempt from tax, is an entity that has the legal status. Usually taxation law provides tax exemption from income for a wide variety of organizations, usually not-for-profit, such as temples, colleges, universities, health care providers, various charities, civic leagues, labor unions, trade associations, social clubs, and political organizations.

☐ **Non-Profit Motive Organization [§2(s)(1)(a)]**

Organizations that are prominent public characters of non-profit motive fall under the tax exempt organizations. These include public characters:

(1) Charitable, (2) Religious, (3) Scientific, (4) Educational, (5) Literary, (6) Preventing cruelty to children or animals, (7) Testing for public safety, etc.

Tax-exempt entity has to follow principle of non-profit motive. If it intends to earn profit to the extent, becomes taxable. Since earning activities of exempt organizations are detrimental to their tax status and the exemption is not extended to amounts derived in conducting a business.

> **EXAMPLE 4-1** A hospital that has been approved as an exempt organization by the IRD, however, it produces handicrafts goods and sells them to tourists; profit from that handicraft business will be taxable.

This limitation is needed in order to ensure that exempt organizations do not compete in the markets where they have a tax advantage over other market participants. Furthermore, assets or amounts that the entity has derived must not provide a benefit to any person unless the benefit is connected with the entity's function or consists of payments for assets or services that the person has rendered to the entity.

Exempt organizations are mainly of a charitable character and depend on donations as a source of income to cover their costs and to fulfill their purpose. In order to give incentives to potential donors gifts are deductible from the donor's taxable income within given limits.

☐ Social and Sporting Association [§2(s)(1)(b)]

Social and sporting associations include a fostering national or international amateur sports competition association formed for promoting social or sporting activities not involving the acquisition of gain. Generally, it includes the following clubs and associations.

1. National, regional and local levels sporting clubs
2. Different types of professional associations like, engineers association, doctors associations, teachers association, professors associations etc.
3. Different types of consumer associations like drinking water consumers associations, mountaineering association, rescue association, hotel association, etc.

☐ Political Parties Registered with Election Commission [§2(s)(2)]

Political parties, which are registered with election commission including their divisions or sub-divisions, are also tax-exempt organizations if they obtained tax-exempt certificate from the IRD.

☐ Political Entities [§2(s)(3)]

Political entities like Metropolitan City, Sub-Metropolitan City, Municipality, District Development Committee (DDC), and Village Development Committee (VDC) are also tax-exempt entities. However, these entities have to obtain tax-exempt certificate from the IRD.

☐ Nepal Rastra Bank [§2(s)(4)]

Nepal Rastra Bank is a Central Bank of Nepal. It supervises banking system and controls the national monetary system.

Central banking systems take various forms. However, most countries have a single institution. In general, central bank operates in some or all of the following five main ways:

1. Central is the government's banker–government revenues are deposited with, and government expenditure is paid via, the central bank, which also holds the government's reserves of gold and foreign exchange. When a government needs to borrow money, it may be the central bank that arranges it.
2. Central bank supervises the banking system, using legal powers and informal influence.
3. Central bank is the banker for the country's various private banks, taking deposits from and lending to them.
4. Central bank functions as a lender of last resort, to provide loans to banks that find themselves in financial difficulty or without sufficient money to pay depositors who want to withdraw their deposits.
5. Central bank issues the currency, with responsibility for keeping it at any level agreed with government, through intervention in the currency markets and/or adjustment of interest rates.

Thus, considering the above facts, ITA 2002 exempts tax to Nepal Rastra Banks and its earnings.

☐ The Government of Nepal (GON) [§2(s)(5)]

In simple, a government means a political authority or a group of people who have the authority to make and the power to enforce rules and laws within a civil, corporate, religious, academic, or other organization or group. In its broadest sense, 'to govern' means to administer or supervise, whether over a state, a set group of people, or a collection of assets. To impose tax for the government by the same government is similar to transfer of money from one pocket to another. The government itself is an entity; thus, tax Act exempts for her income.

But, any benefit acquired by any persons out of the assets of and amounts derived by the entity except in pursuit of the entity's functions as per its objectives or as payment for assets or services rendered to the entity by the person is not exempt from tax.

4.2 EXEMPT AMOUNTS

Generally, incomes, which are exempted from payment of tax, are those incomes that are excluded on sources of income from employment, business and investment. According to the Columbia Encyclopedia – tax exemption is that "immunity from the requirement of paying taxes". Usually taxation law provides tax exemption from income for a wide variety of organizations, usually not-for-profit. Thus, the following amounts are exempted from payment of tax.

☐ Tax Exemption According to Bilateral and Multilateral Treaty [§10(a)]

Those amounts received by a person entitled to privileges under a bilateral or a multilateral treaty concluded between the Government of Nepal and a foreign country or international organizations are tax-exempted income.

> **EXAMPLE 4-2** Assume that Nepal and China agreed to exempt income tax on salary income of the staffs engaged in infrastructure work in each country it should exempt from payment of tax according to agreement. It is an example of tax exemption of bilateral treaty.

> **EXAMPLE 4-3** United Nations Development Program (UNDP) an autonomous arm of the United Nations (UN), established by the General Assembly in 1965. The UNDP works with some 150 governments and 30 intergovernmental agencies to provide technical assistance to improve living standards and promote economic growth in the developing nations of Asia, Africa, Latin America, the Middle East, and parts of Europe. UNDP projects include programs to increase literacy and provide vocational skills, to stimulate capital investments, and to develop technological capabilities. The Government of Nepal has signed on treaty for international organizations. Thus, amounts received by employees of UNDP not taxed in Nepal.

☐ Income of an Individual from Employment of Foreign Government [§10(b)]

Amounts received by an individual from employment in public service of the government of a foreign country are tax-exempted income. But, it has

to satisfy two provisions: the individual should be a resident person or a non-resident person solely based for the reason of employment, and the amounts should be payable from the public funds of the country.

EXAMPLE 4-4 The United States (US) ambassador to Nepal, James F Moriarty, came to Nepal. He receives his salary from public funds of the US Government. In this circumstance, the salary income of Mr. Moriarty is exempted from payment of tax.

EXAMPLE 4-5 Assume that Mr. Moriarty may be non-resident for the first year and resident for the later if he stayed more than 183 days in Nepal for the purpose an envoy of the US.

EXAMPLE 4-6 Assume that Mr. Wade, the US citizen has been staying and doing business in Nepal for last two years. The US government appointed to him an envoy to Nepal too. The person is not entitled to get exemption because he is not resident or non-resident person solely based for the reason of employment.

☐ Receipt of Dependent from Foreign Government [§10(c)]

Amounts derived by an individual, who is not a citizen of Nepal or by a member of the immediate family of the individual, from the public fund of the foreign country.

EXAMPLE 4-7 Assume that Mr. Musee du Louvre, a French citizen has been living in Nepal from last year. However, he receives his diseased father's after death benefit from public funds of the French government According to the Act these after death benefit received by Mr. Louvre, the dependent of the diseased person is not subject to income tax.

☐ Appointment of Foreign National by the Government of Nepal under the Terms of Tax Exemption [§10(d)]

Amount derived from employment by the Government of Nepal on terms of a tax exemption by an individual who is not citizen of Nepal.

EXAMPLE 4-8 A national of the US appointed for service of the Government of Nepal under the terms and condition of tax-exemption. In this circumstance, his income from employment is exempted from payment of tax.

☐ Allowance Provided by the Government of Nepal to disable persons [§10(e)]

The Government of Nepal pays a nominal allowance to disable persons: widows, widower, elder citizens and incapable persons. Such allowances do not fall under the taxable income.

EXAMPLE 4-9 The Government of Nepal provides allowance or Rs. 300 per month to disable persons: widow, widower, elder citizen. According to the Act, the entire amount of such allowance is not included in their taxable income.

☐ **Gift, Will, Inheritance, or Scholarship [§10(f)]**
Amount derived by way of gift, will, inheritance, or scholarship, apart from those required being included in calculating income under employment, business and investment. The value of property received by gift or inheritance is not subject to income tax.

EXAMPLE 4-10 A nephew Nepali resident if got a building from his uncle as will. The fair market value of the willed building on the date of handover was a substantial value. However, whatever value the nephew got will is not subjected to income tax.

EXAMPLE 4-11 Suppose that a natural person, residing in Nepal inherited a building from his father. In this circumstance, son is not subjected to income tax on the building, which he inherited.

EXAMPLE 4-12 A student at a University received funds from a private, non-governmental organization for scientific research work. No conditions are attached to the receipt of the funds. The funds of the student received from this organization constitute a scholarship and are not included in student's income.

☐ **Donation and Gift Income of Exempt Organizations [§10(g)(1-2)]**
Amount derived by an exempt organization by way of donation, gift, or other contributions that directly relate to the social, religious, educational or a charitable organization of a public character registered without profit motive whether or not the contribution is made in return for consideration provided by the organization.

EXAMPLE 4-13 A religious trust received donation and gift from a Corporation. Again, the trust donated some part of its received amount to another social organization and part of it received incurred for its main purposes. In this circumstance, the amount of donation received by the social, religious etc. organization is considered tax-exempted amount.

☐ **Income of Nepal Rastra Bank [§10(g)(3)]**
Amount derived by Nepal Rastra Bank as per its objectives are not taxable incomes. [For detail, please see second last paragraph of exempt organization]

☐ Pension Received from Foreign Government [§10(h)]

Pension received by a Nepali citizen retired from the army or police service of a foreign country received amounts from the public fund of that country are exempt from payment of tax.

> **EXAMPLE 4-14** A citizen of Nepal was an employee of foreign government. He retired from his job. Now, he is receiving after retirement benefit Rs. 20,000 per month as pension from the public fund of that country. However, the pension benefits he received from public funds of the foreign government are not included in his taxable income.

Thus, pension received by Nepali citizen from the foreign government such as India, the Great Britain etc. is tax-exempt income.

4.3 BUSINESS EXEMPTIONS AND PRIVILEGES

Tax exemptions are usually meant either to reduce the tax burden from a particular segment of society in the interests of fairness or to promote some type of economic activity reducing the tax burden on those organizations or individuals who are involved in that activity. Generally, tax privileges system is applied to promote domestic industry. It helps to export domestic production to the international market. To protect and encourage industrial development of the nation many countries apply quota system while importing goods, which reduces consumption of foreign goods.

Due to these reasons, the Act provides several tax exemptions and incentives to the person including industrial units of the country. These reduce tax incidence substantially.

☐ Business Exemptions

The following business incomes are exempted from payment of tax as per §11(1) and (2).

1. Agriculture income [§11(1)]: An agricultural income derived from sources in Nepal during an income year by a person, other than income from an agriculture business derived by a registered firm, or company, or partnership, or a corporate body, or through holding land more than prescribed ceiling in Land Relating Act 2021, is exempt from income tax.

Region and their ceiling of land prescribed by Land Relating Act 2021

Region / place / part of the country	Agriculture	House and compound
Tarai including inner Tarai	10 Bighas	1 Bigha
In Kathmandu Valley	25 Ropanies	5 Ropanies
All hilly areas	70 Ropanies	5 Ropanies

EXAMPLE 4-15 A peasant holds 10 Bighas land in Tarai and produces agriculture products. During an income year, he sold half of his surplus produce and earned income. However, his income is exempt from payment of tax.

EXAMPLE 4-16 A farmer holds 35 Ropani land in Kathmandu and produces agriculture products. During an income year, he sold his surplus produce and derived sales income. In this circumstance, the income of the excess of the five ropani is taxed from agriculture income.

2. Agriculture business [§11(1)]: Agriculture business signifies the business of producing crops from public or private land, or deriving crops from a tenant using the land. For the income tax purposes, income derived by a landlord, holding the land within the ceiling prescribed in Land Act, 2021 from an agriculture business is exempt from income tax. However, income from an agriculture business received by a registered firm, or partnership or company or a corporate body, or through the land above the holding ceiling as prescribed in the Land Act, 2021 is taxable income.

EXAMPLE 4-17 In an income year, a peasant derived sales income from merchandise of his agriculture production. If the crop producing land owned by him is within the prescribed ceiling, the amount of income becomes exempt from payment of tax.

EXAMPLE 4-18 A farmer registered a sole proprietorship business firm to produce crops from his prescribed ceiling land. If he merchandised his produce only from prescribed ceiling land, his income belongs to business income category and it falls under the inclusion for taxable income.

EXAMPLE 4-19 A person owns 31 Bighas land in Tarai including house and compound. If he merchandised part of his produce, his income from agriculture business turns out to be taxable as proportionately deducting his prescribed ceiling.

3. Agriculture business income of a land owned by trust: For the income tax purposes, income derived by a trust from an agriculture

business from land owned by trust is exempt from payment of income tax.

4. Business income of co-operatives [§11(2)]: Income derived by cooperative societies, registered under Cooperative Act, 1991 (2048) from business mainly based on agriculture and forest products such as sericulture and silk production, horticulture and fruit processing, animal husbandry, diary industries, poultry farming, fishery, tea gardening and processing, coffee farming and processing, horticulture and herb processing, vegetable seeds farming, bee-keeping, honey production, rubber farming, floriculture and production and forestry related business such as lease-hold forestry, agro-forestry, cold storage established for the storage of vegetables and business of agricultural seeds, insecticide, fertilizer and agricultural tools (other than machine operated) as well as income derived by rural community based saving and credit cooperatives are also exempt from tax.

EXAMPLE 4-20 A Co-operative Society Limited operates the business of automatic paddy planting and harvesting machine. In its first income year, it earned profit Rs. 900,000. According to co-operative business, it claimed income exempt from payment of tax. However, the IRD showed reason of business of automatic planting and harvesting machine, is not exempt from payment of tax.

EXAMPLE 4-21 Suppose that in an income year a non-rural based a saving and credit co-operative society limited derived taxable income of Rs. 750,000. In this event, the taxable income of the limited is taxed at the rate of 30 percent in equal to financial institution.

5. Dividend income tax of prescribed entities [§11(2)]: Dividend income distributed by agro or forest based co-operatives and rural community based credit co-operative is exempted from payment of dividend tax.

EXAMPLE 4-22 A shareholder of agriculture co-operative Limited (agro and forest based), a credit co-operative Limited (rural community based) and credit co-operative limited (established in non-rural area) if receives dividend income, the dividend of credit co-operative limited (established in non-rural area) is taxed at the rate of five percent for dividend tax.

6. **Income from domestic industry:** Income derived from domestic industries is exempted from payment of income tax to them, which have already taken tax-exempted certificate before than Srawan 1, 2063. After Srawan 1, 2063, there is no provision of tax-exempt certificate to the domestic industries[1]. The domestic industry refers that production intensive industry of labor, traditional, skill relating to art and culture and raw material mobilization of local level excluding wool dyeing, carpet, pashmina and woolen cloth production using more than 5-kilowatt motor power.

☐ Business Privileges

Privileges signify civil liberties or special right given to someone in return for a monetary consideration. Thus, income tax privileges are special right in return for a monetary consideration for payment of tax. According to Black's Law Dictionary, privilege means:

> A particular and peculiar benefit or advantage enjoyed by a person, company, or class, beyond the common advantages of other citizens. An exceptional or extraordinary power or exemption; a peculiar right, advantage, exemption, power, franchise, or immunity held by a person or class, not generally possessed by others (p. 1197).

ITA, 2002 has divided industries into two categories: special industries and industries. The special industry excludes industries producing cigarettes, biddy, cigar, chewing tobacco, khaini, or other goods using tobacco as the basic raw material or alcohol, beer, or other goods of a similar nature.

1. **Income of special industry:** Income derived from an entity having a source in Nepal that is wholly engaged in operating a special industry, an entity that operates any road, bridge, tunnel, ropeway, or overhead bridge construction, and an entity operating any trolley bus is taxed at the rate of 20 percent.

   EXAMPLE 4-23 Suppose that an entity is fully engaged for construction of ropeway throughout the income year. In this situation, the income of the entity is taxed at the rate of 20 percent.

   - **Special industry if provides 600 or more employment throughout the year:** A special industry if provides direct employment to six hundred or more Nepali citizen throughout

[1] Inserted by the Finance Act 2063 dated Srawan 1, 2063.

the year, the tax is levied at the rate of 90 percent of the rate otherwise applicable to the income of that year.

EXAMPLES 4-24 Assume that, a paper industry operated in Nepal, provided 600 or more employees throughout the year in the first income year. But, in the following income year it offered 400 employees first six month and more than 600 employees for the following six months. In this context, the industry can get income tax facility of 90 percent of the rate otherwise applicable for the first income year but it can not eligible to get income tax privilege in the later year.

EXAMPLE 4-25 According to tax law both persons: individual (natural) and entity are permissible to operate special industry. For the case, they are taxed at the rate of:

Persons	Taxable income	If special industry provided 600 or more employees throughout the year, the tax is levied 90% of the rate otherwise applicable.
Entity	Taxable income	18% [90% of the rate 20%]
Natural person	Taxable base [Taxable income– relief]	(1) For the first Rs. 75,000 @13.5% [90% of the rate 15%] (2) In balance Rs.… @ 18% [90% of the rate 20%]

- **Special industry if operated in least developed, undeveloped and underdeveloped areas:** A special industry of a person if it is operated in a least developed, undeveloped or an underdeveloped areas, tax is levied at the rate of 70 percent, 75 percent and 80 percent respectively of the rate otherwise applicable for the period of 10 income years commencing from and including the year in which the operation commenced. Thus, 54 districts out of 75 districts of Nepal fall under these prescribed three zones.

EXAMPLE 4-26 If a person operated special industries in a least developed zone: Darchula, Bajhang, Bajura, Humla, Jumla, Mugu, Kalikot, Dolpa, Mustang, Manang, Solukhumbu, Sankhuwasabha, Khotang, Bhojpur, Achham, Dailekh, Jajarkot, Rukum, Wokhaldhunga, Magdi, Terhathum and Ramechhap, the person is taxed at the rate of 70 percent of the rate otherwise applicable.

EXAMPLE 4-27 Assume that same facts as EXAMPLE 4-26, the person's tax rate/s is/are altered into the following rate/s.

Persons	Taxable income	If special industry operated in least developed zone
Entity	Taxable income	14% [70% of the rate 20%]
Natural person	Taxable base [Taxable income–relief]	(1) For the first Rs. 75,000 @ 10.5% [70% of the rate 15%] (2) In balance Rs. @ 14% [70% of the rate 20%]

EXAMPLE 4-28 If a person operated special industries in the undeveloped zone: Taplejung, Rolpa, Baitadi, Rasuwa, Gulmi, Parbat, Dadeldhura, Pyuthan, Doti, Salyan, Panchthar, Baglung and Sindhupalchok, the person is taxed at the rate of 75 percent of the rate otherwise applicable.

EXAMPLE 4-29 Assume that same facts of EXAMPLE 4-28, the person's tax rate/s is/are altered into the following rate/s.

Persons	Taxable income	If special industry operated in undeveloped zone
Entity	Taxable income	15% [75% of the 20%]
Natural person	Taxable base [Taxable income–relief]	(1) For the first Rs.75,000 @ 11.25% [75% of the rate 15%] (2) In balance Rs. @15% [75% of the rate 20%]

EXAMPLE 4-30 If a person operated special industries in the underdeveloped zone: Kailali, Surkhet, Arghakhanchi, Palpa, Shyangja, Dhading, Lamjung, Tanahun, Gorkha, Sindhuli, Udayapur, Dhankuta, Ilam, Kanchanpur, Bardia, Dang, Nuwakot, Kabhrepalanchok and Dolakha, the person is taxed at the rate of 80 percent of the rate otherwise applicable.

EXAMPLE 4-31 Assume that same facts of EXAMPLE 4-30, the person's tax rate/s is/are altered into the following rate/s.

Persons	Taxable income	If special industry operated in underdeveloped zone
Entity	Taxable income	16% [80% of the rate 20%]
Natural person	Taxable base [Taxable income–relief]	(1) For the first Rs. 75,000 @ 12% [80% of the rate 15%] (2) In balance Rs. @ 16% [80% of the rate 20%]

2. Industries established in remote area[2]: Income derived by industries established in remote area is exempted for the period of

[2] Inserted by the Finance Act 2063 dated Srawan 1, 2063.

10 income years commencing from and including the year in which the operation commenced.

EXAMPLE 4-32 A person selected a zone to set up an industry in remote area. It started to make industry in 2063 and completed in 2065. It started its industry for commercial operation at Baishakh 1 of 2066. In this circumstance, the person's exemption starts since Baishakh 1, 2066 and it ends at the end of Chaitra 2075 for the duration of 10 income years.

3. Industries established in special economic zone: Income derived by industries established in special economic zone is exempted for the period of five income years commencing from and including the year in which the operation commenced. After the completion of the exempted five income years, they are taxed at the rate of 50 percent of the rate otherwise applicable to the income of that year.

EXAMPLE 4-33 A person set up an industry in special economic zone. Assume that it was completed in Ashadh of 2063. It started its industry for commercial operation at Srawan 1 of 2063. In this case, the person's exemption starts since Srawan 1, 2063 and it ends at the end of Ashadh 2068 for the duration of 5 income years.

EXAMPLE 4-34 Refer back to EXAMPLE 4-33, after the completion period of 5 income years, the derived income of the person from industry established in special economic zone is taxed at the rate of 50 percent of the rate otherwise applicable for that year.

EXAMPLE 4-35 Assume that same facts of EXAMPLE 4-34, the person's tax rate/s is/are altered into the following rate/s.

Persons	Taxable income	If special industry operated in special economic zone
Entity	Taxable income	10% [50% of the rate 20%]
Natural person	Taxable base [Taxable income– relief]	(1) For the first Rs. 75,000 @ 7.5% [50% of the rate 15%] (2) In balance Rs. @ 10% [50% of the rate 20%]

4. Information technology intensive industry established in Information Technology Park (ITP): An industry if based on information technology industry and has established within ITP prescribed by the Government of Nepal, the tax is levied at the rate

of 75 percent of the rate otherwise applicable to the income of that year.

EXAMPLE 4-36 A person derived income from information technology based industry established in ITP of Banepa. The place is in a prescribed zone by the Government of Nepal. In this situation, the person's income is taxed exempting 25 percent of the rate otherwise applicable for that year.

EXAMPLE 4-37 Assume the same facts as EXAMPLE 4-36, the person's tax rate/s is/are altered into the following rate/s.

Persons	Taxable income	If information technology based industry is established in the information technology park, a prescribed area by the government.
Entity	Taxable income	15% [75% of the rate 20%]
Natural person	Taxable base [Taxable income – relief]	(1) For the first Rs. 75,000 @ 11.25% [75% of the rate 15%] (2) In balance Rs. @ 15% [75% of the rate 20%]

5. A Special industry operated by natural person: A natural person if involved in operating special industry throughout the year or an entity involved in special industry or exports the goods or involved in infrastructure works is taxed at the rate of 20 percent of the rate otherwise applicable to the income of that year.

EXAMPLE 4-38 Assume that a natural person derived income from export business or operating special industry throughout the year. In this case, the person is taxed at the rate of 20 percent of the rate otherwise applicable to the income of that year.

EXAMPLE 4-39 Assume the same facts as EXAMPLE 4-38, the person's tax rates are altered into the following rates.

Persons	Taxable income	If a natural person operates special industry throughout the year or exports goods.
Natural person	Taxable base [Taxable income – relief]	(1) For the first Rs. 75,000 @ 15% (2) In balance Rs. @ 20% [tax rate reduces to 20% from the rate 25%]

Chapter 5

Special Provisions

5.1 SPECIAL PROVISIONS FOR INDIVIDUALS

ITA 2002 contains a variety of crucial provisions: special provisions for individuals, entities, retirement funds and financial institutions unconnectedly. These are unique attempts of the Act.

5.1.1 Option of the Couples [§50]

In case of married resident couples, each spouse is taxed individually. However, married resident couples can elect to be treated as a couple for a particular income year.

EXAMPLE 5-1 A couple has been engaging in jobs. Being both employed, they decided to be an individual and notified to the IRD in writing and they treated as individual in the first year. After the

end of income year contracted job of wife terminated and she remained goodwife. Therefore, they treated as couple legally. Again in the following year the wife operated a business, both spouses notified to the IRD to submit their income statement jointly, and they treated as couple.

In this case, their income will be clubbed and added together. If the income of both spouses is added up, the basic exemption threshold for couple applies. If the income of both spouses is calculated separately, each spouse can claim the basic exemption threshold for individuals. If a couple elects to be taxed as couple each spouse is jointly and individually liable together with the other spouse that the tax for the couple is paid.

Any widow or widower having any dependents or sustenance is treated as equivalent of couple[1]. Moreover, any single person having any adapted child is also treated as couple.

5.1.2 Medical Tax Credit

A resident natural person can claim a medical tax credit for an income-year for any approved medical costs paid by the individual or through others during the year in respect of the individual. However, such medical tax credit is prescribed up to certain limit. Thus, a resident individual can claim medical facility whichever is lower up to 15 percent of approved medical treatment expenses or Rs. 750. If amounts of medical treatment expenses exceed the prescribed limit, the excess amount is deducted from the income of the following year or years.

Table 5.1: Medical tax calculation sheet

Approved medical costs	Rs. ___xx
15% of the approved medical costs	Rs.__x
Prescribed limit for the medical tax credit	(-)Rs. 750
Result of total of approved and prescribed limit	Rs. (+)/(-)

Box 5.1: Treatment of deduction and forwarding

1. Negative result:
Medical tax credit fully deductible because it is less than Rs. 750 and thus below the prescribed limit.

2. Positive result:
Medical tax credit deductible only up to the prescribed limit of Rs. 750 because it is greater than the prescribed limit of Rs. 750 and remainder to be carried forward to the next income year and added to the medical tax credit of that income year.

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[1] Inserted by the Finance Act 2063 however, it was in practice before this insertion.

EXAMPLE 5-2 An employee fell sick and treated himself incurring Rs. 15,000. But, employer reimbursed that treatment cost. Under this situation, the employee can get medical tax credit and can reduce up to Rs. 750 (15% of the Rs. 5,000) from his tax amount -- tax liability before deduction of medical tax credit -- during the year and excess amount of Rs. 10,000 is transferred to the following income year or years for medical tax credit.

EXAMPLE 5.3 A resident individual earns taxable income. During an income year, she fell sick and treated herself incurring Rs. 7,000. Under this condition, she gets Rs.750 as medical tax credit during the year and remaining balance Rs. 300 (15% of the Rs. 2,000) is transferred to the following year for medical tax credit.

EXAMPLE 5-4 An employee of the partnership firm is benefited for payment of health insurance premium. If it was Rs. 3,500 paid by employer, then he can reduce his tax liability by Rs. 525 for medical tax credit.

EXAMPLE 5-5 An individual earns taxable income. He has made a health insurance under insurance company. In an income year, he paid Rs. 4,000 for health insurance premium. Under this situation, he can reduce his tax liability by Rs. 450 from medical tax credit.

5.1.3 Exclusions from Medical Tax Credit

Approved medical costs do not include the cost of cosmetic surgery. Moreover, if costs incurred in filing prescriptions of diagnosis, or payments for filing prescription bills counting the purchase of medicine as described above are reimbursed by an insurance company under a health insurance plan, they cannot be claimed as a medical tax credit because the taxpayer does not directly pay them.

EXAMPLE 5-6 A resident individual earns taxable income and treats a cosmetic medical for his forearm incurring Rs. 15,000. But, this amount is not permitted for medical tax credit because the amount of cosmetic surgery does not fall under the medical tax credit.

In addition, to get medical tax credit by an individual, the paid amount must appreciate his income in any way.

5.2 SPECIAL PROVISIONS FOR ENTITIES

In legal terms, an entity is something capable of bearing legal rights and obligations. It generally means legal entity or artificial person. Thus, entities are taxpayers with legal structures, however, that are more complex in comparison to individuals, particularly with respect to the relationship between the entity and its shareholders or partners respectively. This situation needs to be provided by special tax rules. Entities are separately liable to tax from its beneficiaries. However, entity is a type of legal body of the group of person or persons and those beneficiaries of the entity even if are treated separate existence. Thus, entities are taxed according to its existence.

5.2.1 Statutory Papers and Entities

Particularly in Nepal, most of the business forms are run under three statuses: sole proprietorship, partnerships and companies. Sole proprietorship is an individual while partnership and companies are entities and they are taxed from a different method. Partnership means a firm that has fewer than twenty partners while private limited company entails sole shareholder to fifty shareholders. Again, limited company involves seven shareholders to a number of shareholders. The chief distinction of the partnership and company is that, partnership does not require statutory papers: Memorandum of Association and Articles of Association.

EXAMPLE 5-7 A family chief registered a firm under Firm Registration Act 2014. Both spouses of family engaged to operate their business. However, it is recognized for sole proprietorship business.

EXAMPLE 5-8 Any two or more persons (except family members), if prepared a partnership deed (orally or in written firm) and established a firm, whether it registered or not. It is known as partnership firm.

EXAMPLE 5-9 An individual person, if prepared Memorandum of Association and Articles of Association and registered his business under company Act even with sole shareholder is known as company.

5.2.2 Separate Liability of Entity from Its Beneficiaries

An entity is liable to tax separately from its beneficiary, who is a person having an interest to participate in an entity. Thus, the entity and its beneficiary are regarded for two different persons for tax purposes. As a

result, transactions between the entity and its beneficiary are possible. These transactions are recognized for tax purposes unless stated otherwise in the Act. The same principle applies to transactions between entities and its managers, whereas a manager in relation to an entity is defined as any person who participates in making senior management decisions on behalf of the entity.

> **EXAMPLE 5-10** Fat and Thin operate Slim Company to run stone business. Fat also operates a furniture business on sole proprietorship while Thin merchandises office equipment. If the Company needs some furniture and office equipment, Fat and Thin may supply furniture and office equipment independently as a supplier.
>
> **EXAMPLE 5-11** Vice Chancellor is the senior post of T.U. s/he has a right to sanction his/her leave her/himself on behalf of an entity. It is an example of decision taken by a chief person on behalf of the entity.
>
> **EXAMPLE 5-12** Twenty shareholders established a Company. It provides employment for 10 staffs including a managing director from shareholders. In an income year, the company furnished taxable income Rs. 500,000. Tax liability born by the taxable income belongs only with the Company not to shareholders or employees.

5.2.3 Taxation of Entities

In broader sense, a company is an aggregation of people (shareholders) who stay together for a common purpose. Usually, company denotes an organization established under the company law. However, for tax purposes it includes corporate body, unincorporated association, committee, institution, society, foreign company, any foreign institution and partnership firm with more than twenty partners.

5.2.4 Distribution by Entities [§53]

Net profit of a company can either be retained or distributed to its shareholders. These distributions of profit are dividends. The term 'distribution' includes a payment of the company to any of its beneficiaries in any capacity or any capitalization of profits [§53(1)].

5.2.5 Distributions and Collateral Benefits

Capitalization may be in the form of bonus shares, which gradually increase the value of the shareholder in the company. Capitalization of profits also includes collateral benefits, which can be characterized as a

kind of hidden distribution of profit. The hidden distribution of profits may be where a company provides the use of a house or of a car free of costs or below market value to the shareholder without showing in its books of accounts the real value of the payment made to the shareholder.

EXAMPLE 5-13 A Banking Company having equity capital Rs. 500 million furnished its taxable income Rs. 150 million. The board of directors declared 10 percent cash dividend and 10 percent capitalization of profit for issuing stock dividend on its equity capital. Thus, the distribution of profits shall be as below:

Table 5.2: Calculation of tax liability and benefits (in million)

Taxable income			150
Less	Tax liabilities [30% of the taxable income]		45
Net profit after tax			105
Less	Statutory reserve [20% of the net profit after corporate income tax]		21
Amount available for distribution			84
Less:	Distribution:		60
	Cash dividend	30	
	Issuance of bonus share	30	
Retained earnings			24

As stated in the above table 5.2 distributions of profits to its shareholders by the company is Rs. 60 million. It is taxed at the rate of 5 percent for dividend tax. Capitalization of profit may create further benefits to its beneficiaries due to the market price but it is not considered so. Retained earning which is transferred to balance sheet is not considered for distribution.

EXAMPLE 5-14 A Company is owned by seven equal shareholders. It provided house facility to its shareholders paying Rs. 170,000 annually. Thus, this amount of rent is considered as hidden distribution of profits by the Company and that is treated as payment of dividend.

If an entity makes sale to its beneficiary at the rate below market price, the difference between market price and selling price has to be considered for distribution by entity and has to be accounted accordingly.

EXAMPLE 5-15 An entity sells a service Rs. 15,000 to its beneficiary. However, in prevailing market it costs Rs. 20,000. In this event, the difference value of the service is to be considered for distribution by entity and it has to be treated accordingly for tax purposes.

Any payments made to a beneficiary by the entity and that are included in calculating the beneficiaries income and those payments if do not reduce the companies capital that are not considered for distribution of profits or dividend. [§53(2)(b)]

EXAMPLE 5-16 Remuneration paid to a beneficiary, who is employed by the company, is not a distribution of profit by the entity.

Thus, distribution of profits and collateral benefits of a company are dividends which represent a return of interest of capital and repayment of capital are the return of the capital itself. The Act provides a profit-first-rule saying that a distribution is a return of capital to the extent that it is not a distribution of profits [§53(5). Repayments of capital are free of tax while dividends are subject to tax.

5.2.6 Dividend Taxation of Entities

Dividends of a resident company to its shareholders are taxed in the form of final withholding payments of tax while dividends of other resident entities are exempt from tax. Other entities such as partnership are exempt from tax. Distributions of dividends, which are derived after deducting tax, are exempted from tax.

EXAMPLE 5-17 Nepal Limited is a resident company. Its registration status belongs to Company Act 2063 of Nepal. The distribution of profits, for instance, dividend paid to its shareholders is taxed in the form of final withholding payments.

EXAMPLE 5-18 Assume the same facts as EXAMPLE 5-17, if a shareholder has owned 100 pieces of shares and face value of the share is Rs. 100 each and company declared 100 percent dividend, the shareholder is entitled to get Rs. 10,000. If ITA 2002 fixes dividend tax at the rate five percent on dividend income, the shareholder gets Rs. 9,500 after reduction Rs. 500 for final withholding tax. The net amount of dividend Rs. 9,500 never grossing up for payment of tax when it arrives in the hand of shareholder.

Dividends distributed by non-resident entity to a resident beneficiary are taxed by including income of the beneficiary.

EXAMPLE 5-19 A resident person is a beneficiary/shareholder of a non-resident entity. The non-resident entity if distributed its dividend to resident person is taxed by including on its annual income tax calculation.

If distribution is made in the form of a collateral benefit it is also subject to a final withholding tax, however, in addition to that benefit needs to be included into the company's income.

EXAMPLE 5-20 A resident entity made a distribution of collateral benefit to its seven beneficiaries by providing its ¼ part of building for resident on free of cost. It costs Rs. 25,000 per annum. In this context, the entity has to include Rs. 25,000 as an income and it has to be treated for distribution of profits to its beneficiaries using principle of final withholding payment.

5.2.7 Liquidations of Entities [§55]

In case where all of the following requirements are satisfied, the distributions are treated as partly a dividend and partly as a repayment of capital of the entity in the proportion that the beneficiary would be entitled to share in the profits and contributed capital of the entity if the interest were disposed off in course of liquidating the entity at that time:

- Where there is a distribution by an entity with respect to the cancellation, redemption, or surrender of an interest in the entity, including a result of liquidation of the entity or where allowed by law, as a result of the entity purchasing an interest in itself,
- The distribution is not and may not be reasonably calculated, in any respect, as approximately referable to the rights of beneficiaries to share in the profits of the entity other than on a complete liquidation, and
- After the disposal the beneficiary to whom the distribution is made is not an associate of the entity.

However, it does not apply to a distribution made by an entity to one of its beneficiaries in course of purchasing an interest held by the beneficiary in the entity in ordinary course of business on a recognized stock exchange.

5.3 SPECIAL PROVISIONS FOR RETIREMENT SAVINGS

ITA 2002 has presented some unique provisions against retirement savings, which includes taxation of approved or unapproved retirement fund, retirement contribution and retirement payments.

5.3.1 Retirement Funds and Approval of Retirement Fund [§63]

A retirement fund denotes any entity established and maintained solely for the purposes of accepting and investing retirement fund contributions in order to provide retirement fund payments to individuals who are beneficiaries of the entity or a dependant of such an individual. The term retirement fund includes both approved and unapproved retirement fund. The Act distinguishes treatment between approved and unapproved retirement funds. The approved retirement fund is that if it has its residence in Nepal and has received approval from the IRD that it complies with the requirements prescribed in the rules.

EXAMPLE 5-21 Employee Provident Fund (EPF) and Citizen Investment Trust (CIT) both were already established before introduction of ITA 2002. In addition, these two are residents entities of Nepal. Therefore, these are approved retirement funds.

5.3.2 Taxation of Retirement Fund [§64]

Income of a retirement fund is computed without including retirement contributions, retirement payments and interests of beneficiaries in a retirement fund. The approved retirement fund's income is exempt from payment of tax. However, the income of an unapproved retirement fund is subject to income tax.

EXAMPLE 5-22 Both EPF and CIT are approved retirement funds. Thus, these two are exempted from payment of tax. If any entity keeps retirement contributions without approval of the IRD and that is also non-resident in Nepal means unapproved retirement fund. Thus, it is subject to income tax and is taxed at the rate of 30 percent as taxed for financial institution.

5.3.3 Retirement Contributions [§63 and Rule 21]

Retirement contributions are payments of an individual made to a retirement fund for the provision or future provision of retirement payments. Individuals can deduct their retirement contributions made to an approved retirement fund from their taxable income. As per Rule 21 of ITR 2002, it is deducted not more than Rs. 300,000 or one third of assessable income for each income year. However, contributions of an individual to an unapproved retirement fund are not deductible from their taxable income.

5.3.4 Retirement Payments from Retirement Funds [§65]

Retirement payments are payments from a retirement fund to an individual in the event of the individual's retirement or to a dependant of the individual in the event of the individual's death. Retirement payments from an approved retirement fund to an individual are to be included in calculating the income of the individual. In case of a lump sum payment, it is treated as a gain from the disposal of a non-business chargeable asset of the individual subject to final withholding. The gain is calculated by deducting 50 percent of lump sum payment or five hundred thousand rupees, whichever is higher from that total of lump sum retirement payment.

5.3.5 Payments of Unapproved Retirement Fund [§65(2)]

Payment of an unapproved fund is up to the extent of the contributions exempt from tax because they are in this case a repayment of capital. The gains are taxed in the hands of the individual recipient in the form of final withholding tax. If a non-resident fund pays out the proceeds they are included in the income of the individual beneficiary.

5.4 SPECIAL PROVISIONS FOR INSURANCE AND BANKING BUSINESS

Banking and insurance businesses are of special nature as compared to other businesses. Considering this fact the Act has made some special provisions to them. According to provisions a banking business or a general or an investment insurance business are treated as separate businesses and the income or loss need to be calculated separately from any other activity.

5.4.1 Banks and Financial Institutions

In satirical saying, "A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain" (Mark Twain, 1910). However, Bouvier Law Dictionary (1856) states out:

> Bank is a place for the deposit of money. An institution, generally incorporated, authorized to receive deposits of money, to lend money, and to promissory notes, usually known by the name of bank notes. Banks are said to be of three kinds, viz. of deposit, of discount, and of circulation; they generally perform *all these operations*.

In simple bank offers business of financial services. In the business that keeps money for individual people or companies, exchanges currencies, makes loans and offers other financial intermediaries services.

According to nature of business financial institutions earns heavy profit or loss within a year. Their profit or loss may be unexpected or depended on its loan recovery and loan loss provision. Thus, a financial institution can make a lot of profit in many years and huge amount of loss in a year. Considering this nature of business, the financial institutions are provided special additional provisions for tax purposes.

5.4.2 Provision of Contingency Fund (Loan Loss Provision)

Banks and financial institutions which deal monetary transaction has an option to deduct up to five percent of the total debt but not more than the limit prescribed by NRB to cover the risk. However, the bank and financial institution cannot deduct again additional amount from income statement as an expense.

> **EXAMPLE 5-23** A bank made a contingency provision of Rs. 10 million (five percent of the total debt not yet recovered or as prescribed by NRB) deducting from its income. It is a creation of liabilities, which is created from income. It cannot make again further deduction from its income keeping its contingency provision without reduction.

5.4.3 Capitalized or Distribution by Contingency Fund

If the banks or financial institution distributed its contingency provision to shareholders as dividend or capitalized, in which year of income it has done so, in the same year it has to make same amount of inclusion on its income.

5.4.4 Provision of Carry Back of Losses

Banks or financial institution if do not enjoy option of contingency provision, however, they incur losses. In this circumstance, they can carry back loss for a period of five years. [§59(2)] For the reason that the yields of the banks and financial institution may vary widely between profits in one year and losses in another year banks are allowed to carry back losses for five years before the carry forward rule applies.

> **EXAMPLE 5-24** If a bank enjoys the option of example 5-23, it can not enjoy the option of carry back loss for a period of five years. If a bank does not enjoy the option of contingency provision but it deducts its contingency from its income it will also give same results. If a bank does not enjoy both options then it gets the carry backward of losses for a period of five years.

However, the deduction of losses as carry back is based on the following points.

- Loss may be recovered up to income derived from the business for the particular preceding income year.
- Loss may be recovered up to total of loss.
- It does not effect the amount of carry forward of loss.

5.4.5 Insurance Business

Bouvier Law Dictionary defines that:

> Insurance business is defined to be a contract of indemnity from loss or damage arising upon an uncertain event. It is more fully defined to be a contract by which one of the parties, called the insurer, binds himself to the other, called the insured, to pay him a sum of money, or otherwise indemnify him in case of the happening of a fortuitous event, provided for in a general or special manner in the contract, in consideration of a premium which the latter pays, or binds himself to pay him.

Insurance businesses may vary widely between profits in one year to losses in another year. However, these businesses have no option of contingency provision or equivalent amounts to make deduction from its income. These businesses are only granted the right of carry back if they conduct general insurance businesses which are registered as per current law of Nepal.

5.4.6 Computation of Income [§60]

The computation of income from insurance business is mostly calculated like the income from any other common business or investment. But, in addition to that, in general insurance businesses as insurer are obliged to include premiums of the insured and compensations from third parties in the computation of their income and they are allowed to deduct insurance payments made or premiums returned to the insured.

5.4.7 Investment Insurance [§2(am)]

According to §2(am), investment insurance is defined as covering the event of death, personal injury or incapacitation of the insured person or an associate, based on an agreement to be in effect for at least five years and terminable by the insurer only in special circumstances as well as in case of reinsurance.

5.4.8 Proceeds from General Insurance

Proceeds from a general insurance received by the insurer are to be included in the income from employment, business or investment if the proceed compensates income or an amount to be included in calculating the income or a loss.

Chapter 6

Withholding

6.1 CONCEPT OF WITHHOLDING

Nepal adopts Pay-Tax-As-You-Earn (PAYE) System of income tax. It is a method of paying income tax during the year of income. In simple, a taxpayer (employee)'s employer deducts tax from his/her salary or wages or pension before paying him/her. It means that the employee pays tax over the whole year, each time s/he is paid. In this event, the employer is responsible for sending the tax on to the IRD/IRO. Thus, under the PAYE system recipient receives his income after deducting the tax.

This system was originated in the Great Britain in 1944 and Sir Kingsley Wood piloted it. However, it is also claimed that, "America was adopted withholding tax on wages in 1943" (Caldwell, 2000). According to this

system, a person must pay tax as s/he earns or receives income during the year. It is also called tax deduction at source (TDS). PAYE system has twofold benefits: (1) it reduces tax evasion -- taxpayer cannot postpone his payable amount of tax to some extent and (2) collection of tax is during the year -- it safeguards the government budget.

ITA 2002 has defined the terms withholding agent, final withholding and withholdee but it has not defined the term withholding. In simple, a withholding tax is a tax automatically taken from income received during the year. Individuals paying too much withholding tax will receive a tax refund; individuals paying too little withholding tax will owe additional taxes at the end of the year.

In addition, tax on income imposed at source i.e. a third party is charged with the task of deducting the tax from certain kind of payments and remitting that amount to the government. Withholding taxes are found practically in all tax systems and are widely used in dividends, interest, royalties, bonuses, commissions, gambling, winnings and similar payments. Where wages and salaries represent the underlying taxable payment, a wage tax is usually levied as a withholding tax. ITA 2002 requires tax to be withheld from a withholding agent.

6.1.1 Treatment of Withholding Payments

Withholding tax may be provisional or final. If provisional, the amount withheld is credited against the taxpayer's final tax liability and adjusted accordingly. The provisional withholding is also called tax credit. If final, no subsequent adjustments are made.

Tax credit is an item that has been already paid to receive a sum of income. It affects the amount of tax to be paid. It exclusively differs from tax deduction, tax allowance or tax relief. These reduces taxable income not tax liability. Final withholding tax is that type of withholding where a person is not entitled to claim the withholding to reduce tax liability and already taxed income by the withholding is not kept under the inclusions.

> **EXAMPLE 6-1** An auditor's firm audited some business organizations and earned income in gross Rs. 200,000. However, the firm received net Rs. 170,000 after withholding Rs. 30,000. In this case, the firm reserves right of tax credit. Thus, its income is to be Rs. 200,000 (Rs. 170,000 plus Rs. 30,000) and withholding tax for tax credit is to be Rs. 30,000. Thus, the withholding tax reduces its annual tax liability.

EXAMPLE 6-2 A person earns business income Rs. 600,000 including net dividend income from resident company Rs. 95,000 after withholding tax Rs. 5,000 on gross dividend income of Rs. 100,000. According to the Act, final withholding tax of dividend income of Rs. 5,000 cannot reduce tax liability and the net dividend income of Rs. 95,000 is excluded from inclusions.

6.1.2 Types of Tax Credit

Tax credits may be characterized as either refundable or non-refundable, or equivalently non-wastable or wastable. Refundable or non-wastable tax credits can reduce the tax owed below zero, and result in a net payment to the taxpayer beyond their own payments into the tax system, appearing to be a moderate form of negative income tax.

A non-refundable or wastable tax credit cannot reduce the tax owed below zero and hence cannot cause a taxpayer to receive a refund in excess of their payments into the tax system. A non-refundable tax credit includes childern tax credit in the UK and medical tax credit in Nepal. According to this principle in the UK, a family with children and an income below £58,000 can claim child tax credit on top of child benefit. But, in Nepal a medical tax credit up to Rs. 750 is merely available to the individual who owes tax.

6.1.3 Withholding Amounts

There are three types of withholding: (1) withholding by employers, (2) withholding from investment returns and fees and (3) withholding from contract payments. Withholding includes both final and non-final payments. Payments that require withholding according to current tax law of Nepal has presented in the following table 6.1.

Table 6.1: Withholding Amounts

§.No.	Withholding agent	Withholding tax	Rate
Withholding on income:			
§87(1)	Resident	Employment income	[1]

[1] In employment income, tax has to deduct from salary of each month. For this, it needs the calculation of: (1) amount of annual salary, (2) amount of taxable base, (3) amount of annual tax, and (3) annual tax is divided into twelve months or as required months on equal basis. The annual tax is calculated on the taxable base as: first Rs. 75,000 at the rate of 15 percent, in balance at the rate of 25 percent and additional tax at the rate of 1.5 percent on marginal limit. The taxable base is obtained after reduction of the following amounts (if exists): (1) reduction for family

	employers		
§88(1)	Resident person	Payment toward natural resources, royalties, service fee, rent and retirement payment	15%
	The Government of Nepal (resident person)	Retirement payment as lump sum basis paid through approved retirement fund	6%
	Resident employer company	Commission paid to non-resident person (employee).	10%
§88(2a)	Resident company	Dividends[2]	5%
§88(3)	Resident banks, financial institution or entity which issues debentures or listed company as per current law	Interest of deposit, debenture or government bund paid to any natural person not related to conducting a business and having sourced in Nepal.	6%
§89(1)	Resident person	Insurance premium paid to general insurance including payment of contract amounts if exceeded Rs. 50,000 (on total amount)	1.5%
§89(3)	Resident person	Contract payment if paid to non-resident requires to withhold tax from a payment on following basis[3]: (a) If the IRD has served the resident person with a written	1.5%

status [(for ordinary natural person: for an individual Rs. 100,000 and for a couple Rs. 125,000) and (for disable natural person: for an individual Rs. 150,000 and for a couple Rs. 187,500)], (2) reduction of pension income (if any), (3) reduction of insurance premium (if any), (4) remote area allowance (if any) and (5) foreign allowance (if any).

2 A dividend is a distribution of money or property paid by the corporation out of the corporation's profits to shareholders. Dividend payments are subject to double taxation, the company/corporation pays tax on its profits and the dividend recipient must pay income taxes on the dividend payment, the same money is taxed twice. The directors of the company/corporation decide if a dividend payment is to be made.

3 Instructed by the Circular of 059/60 dated Bhadra 7, 2059. The circular has instructed withholding on the following amounts as: (a) 1.5% withholding on gross amount — payment made to Security Agency (non-resident) by a Manpower Supply Contract and (b) 15% withholding on gross amount — payment made to contractor only in supply of service.

		notice at the rate specified in the notice; or (b) In any other case, in accordance with the aforesaid case.	
Withholding on gain:			
§88 (2b)	Resident person	Gain from investment insurance (on net gain)	5%
§88(2c)	Resident person	Gains from unapproved retirement fund (on gain)	10%
	Resident person	Lottery, gifts, prizes, winning and any other win-falls gains[4]	25%

☐ Withholding by Employers [§87]

Every resident employer has to withhold tax at the rate as specified in Schedule one from a payment with a source in Nepal that is to be included in calculating income of an employee from the employment.

In case the employer reserves the right or an obligation to deduct and withhold any other amount from the payment and any other law that provides that an employee's income from employment not to be reduced although the obligation of an employer to withhold tax is not reduced or extinguished.

> **EXAMPLE 6-3** Assume that an employee of an organization, whose salary is Rs. 20,000 per month has received a loan. Contractually, the loan is not flexible. It has to repay installment Rs 18,000 per month. Again, the employee is to pay income tax Rs. 2,812.50 per month. In this case, the employer can reduce amount of installment but cannot reduce the amount for withholding tax.

☐ Withholding from Investment Returns and Service Fees [§88]

Where a resident person pays a natural resource, rent, royalty, service fee, or retirement payment and the payment has a source in Nepal, the person has to withhold tax on gross amount of payment at the rate of 15 percent.

If the Government of Nepal or an approved retirement fund makes the retirement payment, the person has to withhold tax at the rate of six percent on the gain as calculated according to the Act.

> **EXAMPLE 6-4** Suppose that an employee retired from the government service with retirement payment of lump sum Rs. 2,200,000. In this situation, the Government of Nepal should

[4] Inserted by §16 of the Finance Act 2063 p. 4.

withhold tax at the rate of six percent on Rs. 1,100,000 out of his lump sum payment of Rs. 2,200,000.

Where a resident person makes the following payments, having source in Nepal, the person has to withhold tax at the rates specified below:

- If the person pays a dividend at the rate of five percent on gross amount of payment,
- If the person pays a gain from investment insurance at the rate of five percent on amount of payment of gain, or
- If the person pays a gain from unapproved retirement fund at the rate of 10 percent on the amount of gain.

Where a resident bank, financial institution or any other institution issuing debentures or company listed under prevailing laws pay the following interest, or any amounts having the nature of an interest to an individual with respect to a deposit, security, debenture or government bond to them which has a source in Nepal and which is not received by the individual in the course of conducting a business, the bank or the institution or the company has to withhold tax on gross amount of payment at the rate of 6 percent. However, this provision does not include the following payments.

- Payments made by an individual other than while conducting a business or payment of rent for the lease of a building,
- Payment of service fee to a resident company,
- Payment of remuneration in respect to article published in newspapers or magazines,
- Payment of preparation of question paper and examiner fee,
- Payment of interest to a resident bank or other resident financial institution, or
- Payment that is exempt from tax or subject to withholding under employers.

EXAMPLE 6-5 A resident natural person took a 10 percent loan of Rs. 100,000 from his friend. In this condition, the natural person is not required to withhold tax from amount of the payment.

EXAMPLE 6-6 A resident company appointed a consultant by the Government of Nepal for an irrigation project settling of consultation fee Rs. 400,000 for a year. Under this state, the Government of Nepal need not withhold tax from the amount of payment.

EXAMPLE 6-7 A writer wrote an article to a Publication Board and is published for a week. The Publication has decided Rs. 1,000 per

article for this banner. To pay remuneration to the writer, the Publication is not required to withhold tax from payment of the gross remuneration.

EXAMPLE 6-8 Mr. Pokhrel prepared question paper and examined copies for MBS students. His remuneration from this work was Rs. 15,000. However, payer of this amount is not required to withhold tax on the gross amount of payment.

EXAMPLE 6-9 Moon Bank took an inter-bank loan from Sun Bank. For this case, Moon Bank is not required to withhold tax on the gross amount of interest payment.

EXAMPLE 6-10 A Co-operative Society Limited is going to distribute its profits to its shareholders. If this co-operative is tax-exempt entity, it is not required to withhold dividend tax on gross amount of payment.

☐ **Withholding from Contract Payments [§89]**

A resident person who makes a payment under a contract, including insurance premiums paid for general insurance, that exceeds Rs 50,000 has to withhold tax on gross amount of the payment at the rate of 1.5 percent. It is to be determined by aggregating a payment made by a person under a contract with any other payment made by the person or an associate of the person during the previous ten days under same contract to the same payee or an associate of the payee. However, if a resident person makes a payment to a non-resident it is required to withhold tax from a payment under a contract as given below.

- In case where the Tax Department has served the resident person with a written notice at the rate specified in the notice; or
- In any other case, in accordance with withholding from contract payments as applied to others.

However, the provision of withholding from contract payments does not apply to the payment made to individuals other than in conducting a business and those, which are exempt from tax or subject to withholding under employer and investment returns or service fee.

6.1.4 Withholding Not Applicable

The withholding payment does not apply to the payment made in the following cases:

- Payment made by an individual other than in conducting a business or payment of rent for the lease of a building
- Payment on service fee to resident company
- Payment made to article published in newspaper and bulletin

- Payment made to preparation of question paper and examiner fee
- Payment of interest to a resident bank or other resident financial institutions
- Payments that are exempt from tax
- Interregional interchange fee paid to credit card issuer bank

6.1.5 Filing of Withholding Amounts [§90]

Every withholding agent ought to file withholding amount with the IRD within 15 days after each month by the prescribed statement specifying the following pictures.

- The payments made to the withholdee from which income tax is required to be withheld,
- Name, address and the withholdee's permanent accounts number, if the withholdee holds one, and
- The tax that has been withheld from each payment.

6.1.6 Failure to File of Withholding Amounts [§90]

Where the withholding agent fails to withhold tax and does not pay the tax withheld to the IRD then as required the withholdee and withholding agent both will be jointly and individually liable for the payment of the amount that should have been withheld. The withholdee in this case is obliged to pay tax within a period of 15 days after the expiry of time limit that the withholding agent had to file a withholding statement and make the payment.

6.1.7 Preparation of Withholding Certificate

A withholding agent is to prepare and serve on each withholdee a withholding certificate in the form as prescribed by the IRD. The withholding certificate has to disclose at least amount of payments made and the tax withheld needs to be stated. It should be delivered within 15 days after the end of month for which tax has been withheld.

6.1.8 Inclusion and Credit for Non-Final Withholding Tax

Withholding tax may or may not be final. If withholding tax is of final nature no further computation or declaration of income tax with regard to the received payment needs to be done from the person on whose behalf the income tax has been withheld.

If withholding tax is not final, withholdee is permitted to a tax credit equal to the withheld amount. Withholdee should claim it during the filing of income tax return. The taxable income then includes the payments that withholdee has received from withholding agent. The tax

liability at the end is reduced by income tax that withholding agent has withheld for this particular sum.

6.2 FINAL WITHHOLDING

According to the existing Act, a portion of income of employee, investment returns including service fees and contract payments are required to be withheld and paid directly to the IRO. These withholding acts as a prepayment as well as final payment of tax and they will not be owed at the end of the year and are known as final withholding payments. The following payments are treated as final withholding payments.

Final withholding is also known as final tax. In many countries, tax is withheld at source from payments—dividends, interest, royalties, wages, etc. at a fixed rate. In such an event, the taxpayer cannot claim any refund of tax withheld, nor can tax authorities charge a higher rate of tax in relation to payments. The tax withheld thus represents taxpayer's final tax liability with respect to those payments in the country of source. A non-resident recipient, however, may well be subject to additional tax on the payments in his country of residence, although that country may mitigate its own tax charge in order to minimize double taxation. Under tax treaties, the withholding tax charged by the country of source may be limited to a rate lower than the rate, which would be charged in other events—this reduced rate is then final tax in the country of source.

Some items of payment include final withholding payments. The following table 6.2 presents to them in summarized form.

Table 6.2: Final withholding

Sources	Withholding agent	Withholding payments	Rate
§88(1), 65(1b) /92(1g)	Government of Nepal (resident person)	Retirement payment as lump sum basis paid through approved retirement fund/paid by the Government of Nepal	6%
§88(1)/ 92(1g)	Resident employer company	Commission (received by non-resident as employee)	10%
§88(2a)/ 92(1a)	Resident company	Dividends (It is a dividend tax, not an income tax)	5%
§88(2b)/ 92(1c)	Resident person	Gain from investment insurance (on gain)	5%
§88(2c)/ 92(1d)	Resident person	Gains from unapproved retirement fund (on gain)	10%
§88(4a)/	Resident person	Rent for the lease of land or a	15%

92(1b)		building and associated fittings and fixtures, having a source in Nepal, and that is received by an individual other than in conducting a business.	
§88(3)/ 92(1e)	Resident banks, financial institution or debenture issuer entity or listed company as per prevailing law	Interest of deposit, debenture or government bund paid to natural person having source in Nepal and that is received by an individual other than in conducting a business, or received by tax exempt entity.	6%
§87, 88, 89/92 (1f)	Any of the above mentioned withholding agents	Any of the above mentioned cases, but payments are made to a non-resident person	Any rate — above
§88/ 92(1h)	Resident person	Meeting fee and payments made for occasional teaching.	15%
§16(FA 2063)	Resident person	Lottery, gifts, prizes, winning and any other win-falls gains	25%

6.2.1 Retirement Payments [§88(1), 65(1b) and 92(1g)]

Retirement payments made by the Government of Nepal or approved retirement fund, where the payment takes the form of a lump sum payment, whichever is higher between 50 percent of that payment or Rs. 500,000 is deducted from that amount and the remaining is treated as a gain from the disposal of a non-business taxable asset of an investment of the individual. The gain from non-business taxable asset from retirement payment is taxed at six percent and it is treated as final withholding payment.

EXAMPLE 6.-11 An employee of the Government of Nepal is going to retire from the post of secretary. The retirement payment is Rs. 1,700,000. Under this condition, the gain from non-business taxable asset turns out Rs. 850,000 and it is taxed at the rate of six percent where his/her tax liability from retirement fund takes Rs. 51,000 and it is treated as final withholding payment.

EXAMPLE 6-12 A staff of TU is going to retire from his/her post. The retirement payment is Rs. 700,000. In this state, the gain from non-business taxable asset turns out Rs. 200,000 and it is taxed at the rate of six percent where his/her tax liability from retirement fund takes Rs. 12,000 and it is treated as final withholding payment.

EXAMPLE 6-13 An employee of National Life Corporation is going to retire from the post of Cashier. The retirement payment is Rs. 400,000. Under this context, the gain from non-business taxable asset turns out to be zero.

6.2.2 Commission [§88(1) and 92(1g)]

Commission paid by resident employer to the non-resident person is taxed at the rate of 10 percent and it is taken into account as final withholding payment.

6.2.3 Dividends Paid by a Resident Company [§88(2a) and 92(1a)]

Dividend amounts paid by resident company is taxed at the rate of five percent as dividend tax and it is treated as final withholding payments. The law of dividend does not discriminate the status of recipients, however, it discriminates status of payers.

EXAMPLE 6-14 A Company and an individual both are shareholders of a resident bank. The shareholders are resident and non-resident for the income year. If they received 95 percent net dividend after withholding dividend tax at the rate of five percent on the gross amount on the basis of their equity investment in that case they need not to make inclusion such final withholding payment in their taxable income irrespective their residential status.

6.2.4 Gain from Investment Insurance [§88(2b) and 92(1c)]

Investment insurance means insurance which covers the event of death, injury, or becoming incapacitated in a particular manner of an individual who is insured or an associate of the insured person having period five or more than five years under which an amount or series of amounts is to become payable to the insured in future. The gain from investment insurance is taxed at the rate of five percent and it remains final withholding payment.

EXAMPLE 6-15 An insuree is going to receiving his investment insurance due to maturity Rs. 200,000 from life insurance company, a resident person. Assume that the insuree was insured by Rs. 100,000 for 15 years and his/her total premium up to last installment was Rs. 109,000. In this state his/her gain from investment insurance belongs Rs. 89,000 and the amount is taxed at the rate of five percent. The levied tax from this gain from investment insurance is confored as final withholidng.

6.2.5 Gain from Unapproved Retirement Fund [§88 (2c) and 92(1d)]

An unapproved retirement fund may be contributed by employer only and sometimes may be contributed by both employer and employee. If both contribute it, the contribution to retirement fund contributed by the employer is added to arrive at assessable income, however, contributed amount by both are not deducted to arrive at taxable income. Thus, in unapproved retirement fund other than gain is already taxed amount. Therefore, net gain from unapproved retirement fund is taxed at the rate of 10 percent and the tax is treated as final withholding.

EXAMPLE 6-16 An employee is going to withdraw his unapproved retirement fund where the total amount is Rs. 240,000 including interest earned on contribution to unapproved retirement fund. The amount of contribution made by employer and employee is Rs. 80,000 and 120,000 respectively. In this context, net gain from unapproved retirement fund stands Rs. 40,000. The tax levy is taxed at the rate of 10 percent on Rs. 40,000 and the amount of tax is taken as final withholding.

6.2.6 Rent for the Lease of Land, Building and Fittings Received by an Individual [§88(4a) and 92(1b)]

Rent for the lease of land or a building and associated fittings and fixtures, having a source in Nepal received by an individual natural person other than in conducting a business is taxed at the rate of 15 percent and, treated as final withholding.

EXAMPLE 6-17 An individual owns a building in Kathmandu Metropolitan City. He occupies one third and rents rest of the building to a resident bank for Rs. 150,000 per annum. The individual owner does not receive any business income during the year but receives rent income Rs. 132,500 after withholding 15 percent on gross rent income. In this situation, the rent income received from resident bank set for final withholding.

EXAMPLE 6-18 A natural person runs a business and owns a house. He leases house to a Private Company and receives Rs. 42,500 after withholding Rs. 7,500. In this context, the rent income is to be grossed up to Rs. 50,000 in investment income and withholding amount has to be adjusted while calculating final tax payment.

EXAMPLE 6-19 An individual owns a house in Birgunj and leases to students. He receives Rs. 20,000 rent income per month. If he does not receive any income from business, he has to pay tax at the rate of 15 percent on his gross income considering its final withholding nature of payment.

6.2.7 Interest on Deposit or Debenture Paid by Financial Institution or Listed Company

Interest paid by a bank or financial institution or listed company to an individual other than in the course of conducting a business or an exempt organization and having source in Nepal is a final withholding payment. Where a resident bank or financial institutions or which issue debentures or any other institutions listed under governing laws, pays interest, or any amounts having the nature of an interest to an individual with respect to a deposit held with the bank or institution, the bank or financial institution are required to withhold tax on the gross amount of payment at the rate of six percent.

EXAMPLE 6-20 An employee having source in Nepal received employment income Rs. 120,000. He purchased debenture of listed company and earned Rs. 9,400 as interest income after withholding Rs. 600, the interest income Rs. 9,400 becomes final withholding.

EXAMPLE 6-21 A writer received royalty Rs. 100,000 from book publisher and in the same year, he also received Rs. 18,200 interest income from financial institution after deducting tax at source Rs. 1,200. The amount of interest Rs. 18,200 becomes final withholding which is not required to be included in the taxable income while royalty income comes to inclusion on investment income.

6.2.8 Occasional Payments [§88 and 92(1h)]

Payment from occasional teaching or meeting fee received by anyone is taxed indiscriminating his other heads of income at the rate of 15 percent and it is taken as final withholding payment.

6.2.9 Windfall Gain Tax [§16 of Finance Bill 2063]

Payment from lottery, gifts, prizes, raffle, quiz, and any other similar benefits received by anyone in the case of winning is taxed indiscriminating his other heads of income at the rate of 25 percent and it is taken as final withholding payment.

6.2.10 Payments to Non-Resident Persons [§92(1f)]

Payments from employment, investment including business and contract business that are made to non-resident person by deducting tax at the rate similar to resident person. Such payments made to non-resident persons are considered final withholding payment.

Chapter 7

Deductions from Business and Investment Income

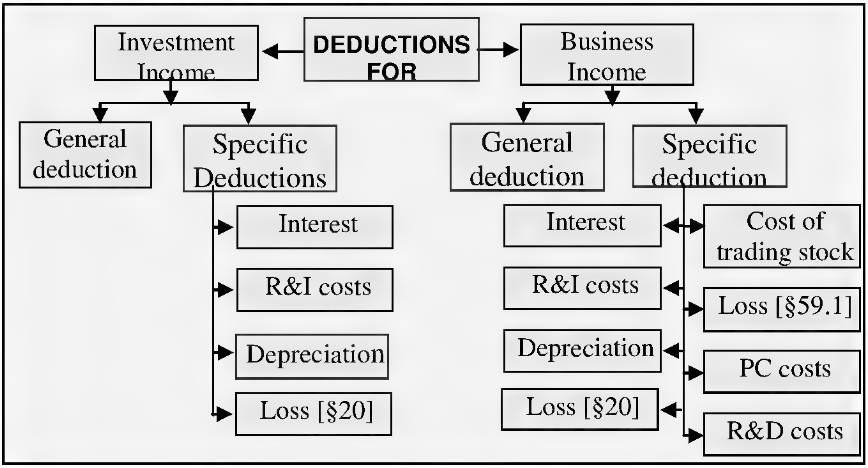
In general, deductions are costs or expenses or outgoing payments made by a person while receiving or earning income. These costs or expenses may be of various forms and types: operating, accrued, variable, fixed, loss adjustment, miscellaneous etc. In addition, deductions may be in the form of cash or non-cash costs, allowances and expenses.

ITA 2002 divides income into three heads for all profit and gains of a person. Proper classification of costs and expenses is crucial to determine how business or investment income and their costs or expenses are to be reported for income tax return. An individual can derive income from

any one head, either of two heads or of all heads. However, entity can derive only from two heads i.e., business and investment. Employment head does not contain any deduction in calculating assessable income from employment.

ITA 2002 classifies all expenses into nine broad heads including costs and allowance. There are five common heads for business and investment and additional four heads applied to business income only.

Figure 7.1: Classification of deductions



Deductions are amounts that are subtracted from inclusions or profit and gains. Any costs or expenses if not subtracted from inclusions recognize taxable. According to ITA 2002, all deductions can be divided into two broad heads for the purpose of simplification as:

(I) General deductions, and
(II) Specific deductions.

Specific deductions include particular nature of deductions either semi-capital or statutory limit proportionately by percent of its portion. To make easier, the specific deductions can be further classified into seven/eight sub-heads as:

- Interests
- Cost of trading stock
- Repair and improvement (R&I) costs
- Pollution control (PC) costs
- Research and development (R&D)costs
- Depreciation allowances
- Losses [§20 and §59]

7.1 GENERAL DEDUCTIONS [§13]

Expenses are deductible as general deductions if they are incurred while earning or receiving assessable (inclusion) income or in carrying business to earn income. The significant objective is that general deductions are part of the process of earning income. All actual expenses of general deduction to the extent it is incurred to generate income from business or investment are allowed as deduction if they satisfy following conditions.

1. If incurred during the year;
2. If incurred by the person; and
3. If incurred for receiving or earning income from business or investment.

However, expenditure will not de deductible if it is private or capital in nature. For example, the private portion of expenses of telephone, electricity, motor vehicle expenses and interest will not be deductible. In addition, capital costs are not allowed as a general deduction but they may be claimed as a specific deduction. For example, the cost of purchasing an item of machinery cannot be claimed as general deduction but it is entitled to an annual claim for depreciation over the life of an asset.

The expenses, charges or fees of general deductions offer justifications. Thus, those are briefly explained as given below:

☐ Advertisement

In simple situation, advertisement expenses—public announcement in a newspaper or on the radio, television, or internet advertising: a product for sale or an event—are deductible from business or investment income. Moreover, cost of institutional or goodwill advertising, if it is related to business and can reasonably generate gain in future, are also deductible expenses. However, advertisement expense made for another person or goods of another person is not deductible expense.

EXAMPLE 7-1 Advertising expenses made by the business organization or investor, if encourages people to contribute to control air, soil, and noise pollution or other similar cases, is usually deductible.

EXAMPLE 7-2 Assume that person “A” is an agent of person “B”. The person “B” produces spots goods: football, volleyball, tennis ball etc. But, the agent makes advertisement expense to sell them in market. Under this situation, the agent can not deduct expense of advertisement.

EXAMPLE 7-3 Refer back to example 7-2 in this context, if the agent is only available after making the advertisement expense or advertisement expense is compulsory to get the agent becomes deductible expense of advertisement to the agent.

☐ Bonus, Gifts and Presents

Bonus, gifts and presents, if made in a normal course of business as a device to sales promotion are taken into account as business expenses on advertisement, publicity and sales presentation. However, the gift and presents of personal nature are not deductible.

☐ Brokerage or Commission for Letting Premises

Brokerage or commission paid for letting premises is deductible as expense. However, the commission more than income from one month rent or lease is non-deductible in practice.

☐ Commissions, Bonuses, and Fees

Commissions, bonuses, fees, and other amounts if paid to get a lease on property that is used in business are capital costs. These costs must amortize over the term of the lease. It is a provision of GAAP however, ITA 2002 has not made any provision of amortization other than capital expense of pool "E".

☐ Commitment Charges to Raise Loans

Payment of commitment charges in respect to raise loans for the purposes of business or investment is deductible as business or investment expense. In addition, brokerage charge paid to an agent for arranging any loan for business purposes are also deductible. The charges include stamp duty, registration fee, lawyer's fees, brokerage or commission paid to an agent for arranging any loan etc.

☐ Compensation

A usual compensation expense paid by the business or investment is deductible. However, compensation paid against breaking the rules except protection of business interest is not deductible.

☐ Costs and Fees of Newspapers and Magazines

Costs and fees incurred for professional, technical, innovation, research and trade journals that deal with business field are deductible.

☐ Expenses of Utilities

Expense related to utilities: heating, lighting, power supplying, telephone service, and water and sewerage of the business are deductible. But, any part attributable to personal use is not deductible.

☐ Demurrage

Payment of demurrage is incidental to a business. It is an allowable deduction in India. The Indian taxation law treats as rent to the demurrage but the Nepalese taxation law treats as fine[1].

☐ Discount and Commission

Discount is reduction in price and commission is fee paid to agent or employee. Discount may be treated by two methods such as by reducing its price in invoice and creating a payment through credit note. Discounts and commissions expenses if paid from business or investment income are deductible. However, it must satisfy the following conditions.

1. Discount, commission and rebate or other similar expenses must be provided with regular invoice.
2. Discount and commission if granted by the credit note that must be proved by bank passbook.
3. Recipient must be known with first name, last name and address.
4. Transactions should be impossible without this discount and commission relieves.
5. Sole agent, super stockiest, dealer, sub-dealer, wholesaler or other similar secondary and tertiary businesspersons are not competent to offer these relieve more than they have really received.

☐ Fines and Penalties on Contract

Fines or penalties paid for late performance or nonperformance of a contract are generally deductible if they were paid for protection of further losses.

> **EXAMPLE 7-4** A person contracted to construct a building. Due to construction delay, the building is not completed and not ready for dwelling on the date specified in the contract. In such condition, the contractor has to pay an additional amount for each day beyond the completion date specified in the contract. These additional costs are deductible business expenses.

However, fines or penalties paid to any central government or local government of government agency because of a violation of any law are not deductible.

> **EXAMPLE 7-5** A business organization violated existing rules of local government. An authority of the local government charged to organization and paid penalty of Rs. 5,000. In this context, the

[1] Inserted by the Finance Ordinance 2062 dated of Magh 1, 2062. But, Finance Act of 2063 does not state any provision about demurrage.

amount of penalty falls under non-deductible expense for the business organization.

☐ Illegal Business

Illegal business is as good as any other business for income tax purposes. It is, therefore, justified to deduct expenses incurred in ordinary course of that business.

☐ Payment Relating to Inquiry

Payments made by a person in connection to business inquiry in course of business are deductible expenses.

☐ Insurance Premium

Insurance premiums paid to insurance company to protect trading stock from damages are deductible and amounts received from such policies are chargeable as trading receipts.

> **EXAMPLE 7-6** A Business Organization paid Rs. 20,000 in insurance premium to its office building and contents against fire and theft. The insurance premiums are not repayable and these payments will be deductible to the extent they meet the requirements of: incurred by the person, incurred during the year and incurred for receiving or earning of income.

☐ Legal Charges or Professional Fees

Legal charges or fees paid to any professional accountants, auditors, or lawyer that are required and directly related to the business, are deductible business expenses. However, legal fees paid in order to acquire business assets are not deductible. These costs are added on business assets.

Legal charges or fees paid for work of a personal nature are not allowed as a business deduction. If the invoice includes both business and personal charges, the portion of the business is only deductible.

> **EXAMPLE 7-7** A manager of a business organization incurred legal charges of Rs. 10,000. It constitutes equal as business and personal purposes. In this situation, only Rs. 5,000 is deductible expnese from business income.

☐ Membership Fees and Club Dues

A membership fees paid to trade, business or professional associations are deductible. However, amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or any other social purpose are not deductible.

☐ Salary and Perquisite to Former Employee

Salary, salary in lieu of leave or any dues in the form of salary or any perquisites paid to former employee are deductible amounts. Moreover, any gratuity or pension paid to former employees is also deductible amount.

☐ Salary and Perquisite to Present Employee

Salary and perquisite paid to present employees are deductible amounts. However, in critical position the following factors and other pertinent facts should be considered.

- Duties performed by the employee.
- Volume of business handled.
- Character and amount of responsibility.
- Complexities of business.
- Amount of time required.
- Cost of living in the locality.
- Ability and achievements of the individual employee performing the service.
- Pay compared with the gross and net income of the business, as well as with distributions to shareholders if the business is a company/corporation.
- Business organization's policy regarding pay for all employees.
- History of pay for each employee.

☐ Sick and Vacation Pay

Payment made to employee towards sickness and injury including lump-sum amount as wages is deductible expense. Vacation pay is an employee benefit. It includes amount paid for unused vacation leave. Thus, these are also deductible. Salary paid to the proprietor of the business is not an allowable deduction in India and Nepal. Such payments are appropriated from profit of the proprietor.

However, if any proprietor takes salary from his proprietorship business, then he is not entitled to get reduction for family from taxable income.

☐ Taxes on Profession

Any profession tax paid by any person carrying business or profession is deductible.

☐ **Tax Preparation Fees**
The cost of hiring a tax professional, such as a C.A. or any kind of professional accountants or auditors, to prepare that part of the tax return relating to business or investment is deductible expense.

☐ **Telephone Charges**
Charges (including any service fee or taxes) of telephone related to business or investment are deductible. The telephone line owned by proprietor and charges for business long-distance phone calls on that line, as well as the cost of a second line into the proprietor's home used exclusively for business, are deductible expenses. However, the costs of basic local telephone line owned by others and not proved by agreement or costs of the private calls are not deductible.

☐ **Training**
Payments made to increase the employee efficiency from training are allowable deduction. But, payments to take a degree or academic qualification only are not deductible amounts.

☐ **Traveling**
To be deductible for tax purposes, expenses incurred for travel must be ordinary, necessary, directly related, or associated expenses incurred while carrying on business or investment. In addition, the travel expense has to justify the following particulars.

- Related with at least transactions,
- Necessary for business or investment,
- Matching with spent time, and
- Internal decision to travel (in company decision of the board meeting by minute).

7.2 SPECIFIC DEDUCTIONS

Specific deductions are distinctive subtraction of costs or expenses or allowance related to particular items. These are particularly related to interest, cost of trading stocks, PC, R&D, R&I, losses, and depreciation. These deductions are classified into eight sub-heads. The sub-heads can be grouped under: (1) four on costs, (2) one on allowance and (3) three on neither costs nor expenses. The following is detail elucidation of each sub-heads of specific deductions.

7.2.1 Interest Deduction [§14]

Interest is an amount charged to borrower for privilege of using lender's money. It is usually calculated as a percentage of the principal balance of

loan. The percentage rate may be fixed for the life of loan or it may be varied, depending on the terms of loan. In other words, interest is a fixed charge for borrowing money; normally a percentage of the amount borrowed.

Rules for deducting interest vary depending on whether the loan proceeds are used for business, personal, or investment activities. If the proceeds of a loan are used for more than one type of expenses, it requires making allocation to determine the interest for each use of loan's proceeds.

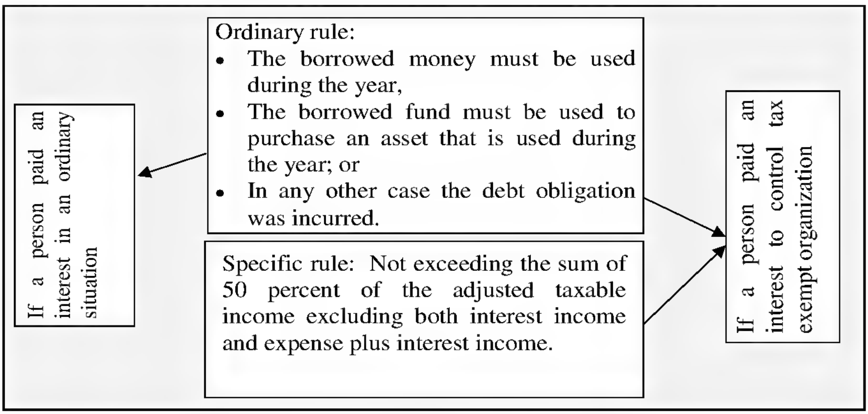
The interests of borrowed funds are allowed to be deducted if incurred in course of conducting a business or investment. The borrowed funds, for which interests are paid, should be used in that production or used to acquire an asset used in that production. Thus, the loan should satisfy the following conditions to deduct its interests from business or investment income.

1. The borrowed money must be used during the year,
2. The borrowed fund must be used to purchase an asset that is used during the year; or
3. In any other case, the debt obligation was incurred.

Deductibility of the interest again depends on the following conditions:

(a) Interest paid in ordinary situation
(b) Interest paid to tax-exempt organization that controls to the payer

Figure 7.2: Ordinary and specific rules for interest deductions



☐ Borrowed Fund and Its Use

Interests of unused borrowed funds are non-deductible to the extent that of the unused from the income of business or investment.

> **EXAMPLE 7-8** A person took a loan Rs. 500,000. However, the person used borrowed capital only Rs. 300,000 in business. In this situation, the person cannot deduct whole interest of the loan from the business income. The deduction of the interest is to limit to the extent of used loan of Rs. 300,000.

☐ Borrowed Fund May be Used to Acquire Working Capital

Interest of loan may be deductible when borrowed money is used to acquire working capital: stocks of business, prepayments, advance to parties etc. But, it is not valued that whether stocks acquired by the borrowed funds are sold or not.

☐ Assets Procurement and Use of Assets

If borrowed fund is used to procure an asset, it must be used to generate income during the year. In addition, the person must own the assets. The interest of the borrowed funds used to acquire denied property is not allowable deduction from income of the business or investment.

☐ Debt Obligation Created by Other Cases

If borrowed money is used to settle due salary of the employee or to settle the creditor; interest of the borrowed fund is also deductible from income of the business or investment.

☐ Deduction of Interest without using Borrowed Fund

Interest on unpaid purchase price of any business asset or stock is deductible amount if a person makes it during the year. In this context, the unpaid value is treated as borrowed fund.

The above stated cases for interest are used in ordinary situation where an independent person takes loan from an independent organization.

☐ Interest paid by a Resident Entity to Controlled Tax Exempt Organization

An entity is an exempt controlled resident entity for any income-year if it is a resident entity for the year and at any time during the year 25 percent or more of the underlying ownership or control of the entity is held by:

(a) Tax exempt organizations or associates of tax exempt organizations,
(b) Persons or associates of persons entitled during the year for tax exemption,
(c) Non-resident persons or associates of non-resident persons, or

(d) Any combination of persons as explained above.

EXAMPLE 7-9 A resident entity is a profit motive entity. It has 15 owners (shareholders). Among the owners, one is tax-exempt organization, which holds more than 25 percent of its shares. It is called entity controlled by tax-exempt organization.

If the interest is paid by a resident entity to that controlling entity, the deduction must not exceed the sum of all interests that are to be included in the entity's taxable income plus 50 percent of the entity's adjusted taxable income whereas the adjusted taxable income is calculated without including any interest derived by the entity and not deducting interest amounts and excluding in calculation for donation amount, R&D cost and PC cost.

In simple way, the above principle may be expressed as 'not exceeding the sum of 50 percent of the adjusted taxable income plus interest income'.

EXAMPLE 7-10 A Plain Press is a resident entity (taxable) that is controlled by a Check (tax-exempt) Organization. The case applies to Plain if it takes loan from Check Organization and pays interest to same organization.

EXAMPLE 7-11 The following is income statement of Himal Company. Calculate allowable interest for the relevant income year.

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Sales	4,200,000
Purchase	2,445,000	Interest income	128,000
Freight	260,000	Compensations	50,000
General expenses	290,000	Closing stock	100,000
Interest	650,000		
Depreciation	105,000		
Costs of R&I	78,000		
Costs of R&D	550,000		
Net profit	50,000		
	4,478,000		4,478,000

Additional information:

1. Himal Company is controlled by tax-exempt organization.
2. Interest signifies already grossed up amount according to the current law on tax credit.
3. Payment of interest recognizes as paid to tax exempt controlled entity.

Solution:

Adjusted taxable income		Amount	Amount
Equals	Total inclusions excluding interest income		4,250,000
Less	General deduction	290,000	
	Cost of trading stock	2,655,000	
	Costs of R&I	78,000	
	Depreciation allowance	105,000	3,128,000
Adjusted taxable income			1,122,000
50% of the adjusted taxable income			561,000
Add:	Interest income		128,000
	Maximum limit available for interest deduction		689,000
	Interest paid to tax exempt controlled entity		650,000
Thus, Rs. 650,000 amount of interest is deductible for the year.			

Therefore, in this situation, the allowable interest for deduction is Rs. 650,000. If the amount excess to maximum limit like Rs. 689,000 is to forward to the following income year for deduction.

However, the excess interest is neither capitalized nor disposed. Thus, excess payment of interest to the tax exempt controlled entity is neither a cost nor an expense.

7.2.2 Cost of Trading Stock

Trading stock is a factor, which affects the person's taxable income from its fluctuation. When opening and closing stock are overvalued it proportionately reduces or appreciates profit accordingly and vice versa. Therefore, for calculating a person's income for an income year from any business, no other deduction is allowed for the cost of trading stock except the allowance determined in relation to the cost incurred in the disposal of trading stock of the person's business during the year.

In accounting, the cost of goods sold describes the direct expenses incurred in producing a particular goods for sale, including the actual cost of materials that comprise goods and direct labor expense in putting goods in salable condition. Cost of goods sold does not include indirect expenses such as office expenses, accounting, shipping, advertising, and other expenses that can not be attributed to a particular item for sale.

The revenue from merchandise sold must match with the cost of trading stock. Cost of sales or cost of goods sold is the identification of the cost of those items sold in most recent accounting period. In short, it is equal to beginning stocks plus purchase less closing stock. The details of cost of trading stock are given below:

Table 7.1: Calculation of cost of trading stock

Cost of trading stock		Amounts
Equals	Value of trading stock of a business at the beginning of the year/value of trading stock of a business at the end of last year.	×
Plus	Cost of purchase of trading stock of the business during the year	×××
Less	Cost of purchase return (if any)	(×)
Plus	Cost of custom duty on purchased stock	×
Plus	Cost incurred for delivery of stocks	×
Less	Closing value of trading stock of the business at the end of the year.	(×)
Cost of trading stock		×××

The above stated cost of trading stock never includes indirect or fixed charges of the firm.

EXAMPLE 7-12 A person disclosed the following Income Statement for the previous year.

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Sales	1,090,000
Purchase	900,000	Compensation	125,000
Custom duty	15,000	Closing stock	127,000
Delivery costs	30,000		
R&I costs	20,000		
Salary	168,000		
Printing & stationery	9,000		
Net profit	150,000		
	1,342,000		1,342,000

Additional information:

1. Opening and closing stocks are under and overvalued by 5 percent.
2. Purchase return of Rs. 25,000 is not deducted from the purchase account.
3. Custom duty includes firm's renewal charge of Rs. 5,000.
4. Additional delivery costs of Rs. 15,000 are not included in the above income statement.

Compute cost of trading stock for the year.

Solution:

Cost of trading stock			Amount
Equals	Opening stock Add: amount of undervalued	50,000 2,632	52,632

Add:	Purchase 900,000 Less: purchase return (25,000) Custom duty (Rs. 15,000- firm's renewal charge Rs. 5,000) Delivery cost (Rs. 30,000+additional amounts Rs. 15,000)	875,000 10,000 45,000	930,000
Less:	Closing stock Less: amount of overvalued	127,000 6,048	120,952
Cost of trading stock			861,680

☐ Matching Concept

Matching concept is one of the most important fundamental accounting concepts. It is also known as accrual concept. Under accrual concept, revenue and costs are credited or charged to income statement for a year in which they are earned or incurred, not when any cash is received or paid.

> **EXAMPLE 7-13** If a person sells article and deducts corresponding cost from its stock, is called matching concept. If incurred cost is on credit, the account has to show exact liability. In case it is not possible to show exact amount of liability, the person has to show an estimated liability for the expected amount of the invoice.

Thus, the matching concept is an alternative term for the "accruals concept" one of the fundamental accounting concepts.

☐ Value of Closing Stock

Stock at the end of a year is also known as closing or ending stock. This closing stock will usually become beginning stock of the following income year. The closing value of trading stock of a business for an income year is the cost of the closing stock or market value of the closing stock whichever is lower at the end of the income year.

> **EXAMPLE 7-14** At the end of the income year a closing stock of a business organization is Rs. 70,000 but its prevailing market price is Rs. 60,000. In this situation, the closing value of stock in income statement is to be quoted on the prevailing market price of Rs. 60,000.

☐ Cost of Trading Stock and Method of Accounting

Cost of trading stock of a business in an income year has to be determined as per underlining rules:

1. **Cash basis accounting:** A person if maintains his books of accounts on a cash basis to calculate the income from business in that

case he is permitted to adopt prime cost or absorption cost method of accounting.

(i) **Prime cost method:** Prime cost is the combination of direct materials and direct labor. If a business adopts prime cost method, the cost of trading stock is to be determined by adopting GAAP under which the cost of trading stock is equal to sum of "direct material cost, direct labor costs and variable factory overhead costs".

(ii) **Absorption cost method**: In 2005, Riley defines:

> Absorption costing is a method of identifying and ascertaining the cost of products or services. This is done by including both fixed and variable costs. The absorption method of costing can be contrasted with variable or marginal costing methods where costs of products or services are calculated using variable costs only. The absorption costing method requires the choice of an "absorption basis" by which fixed costs can be allocated appropriately. For example, the fixed costs of factory equipment repairs and maintenance may be allocated to the cost of producing specific products on the basis of their use of machine time. In another example, the cost of factory rent and rates may be allocated to products based on the amount of factory space that their production takes up.

If a business adopts absorption cost method, the cost of trading stock is to be determined by adopting GAAP under which the cost of trading stock is equal to sum of "direct material costs, direct labour costs and factory overhead costs."

2. Accrual basis of accounting

One of the fundamental accounting concepts, the accruals concept is also known as the "matching concept". Under the accruals concept, revenue and costs are credited or charged to the profit and loss account for the year in which they are earned or incurred, not when any cash is received or paid.

EXAMPLE 7-15 If a sale is made on credit this year, but the cash is only received next year, the sale is treated as income in this year. Similarly, if a business incurs a cost during the year—electricity, telephone, water charge—but is not invoiced until early in the next year, the accounts will show an estimated liability for the expected amount of the invoice.

A person if maintains his books of accounts on an accrual basis in calculating the income from business then he is permitted to adopt the absorption method of accounting for tax purposes.

☐ If Cost of Trading Stock cannot be readily Determined

If cost of trading stock of a business cannot be readily determined, the person may choose to determine it according to first-in-first-out method or average cost method.

1. First-in-first-out method: In first-in-first-out method, the cost of trading stock is determined by adopting GAAP under which the trading stock valuation is based on the assumption that the trading stock is disposed off in order of its acquisition.

2. Average cost method: Average cost represents the average cost per unit of output. It is calculated by dividing total costs, both fixed costs and variable costs, by the total units of output. In average cost method, the cost of trading stock is determined by adopting GAAP under which the cost of the trading stock is determined based on the weighted average cost of all trading stock of similar types held by the business.

EXAMPLE 7-16 If total costs are Rs. 250,000 (comprising fixed costs of Rs. 150,000 and variable costs of Rs. 100,000) and total output units are 10,000, in this situation, the average cost is Rs. 25.

☐ Permission to Change Costing Method

Costing method refers prime cost and absorption cost method. Thus, once selected, the method can only be changed with a written permission by the IRD.

Sometimes, the cost of trading stock requires validation or good reasons for deduction. Some of the reasons are explained below:

☐ Donation from Inventory

If a person contributes stock of trading, the amount can be claimed as a contribution duduction at lowest prevailing market price on the day it was contributed or on its cost basis. The basis of donated stock is any cost incurred for the stock in an earlier year that would otherwise be included in opening stock for the year of contribution. This must remove the amount of contribution from opening stock. It is not part of the cost of goods sold.

If the cost of donated stock is not included in opening stock, the stock's basis is zero and cannot claim a charitable contribution deduction.

☐ Cost of Items Withdrawn for Personal Use

If a person is a merchant, he has to use the cost of all merchandise bought for sale. If a person is a manufacturer or producer, this includes the cost of all raw materials or parts purchased to manufacture finished product. The cost of items withdrawn for personal use has to be deducted from stock plus cost incurred to the extent.

☐ Trade Discounts

The differences between stated prices of articles and actual price paid for them are called trade discounts. A person must use the prices as paid in figuring his cost of purchases.

☐ Cash Discounts

Cash discounts are amounts, which suppliers of the goods let to deduct from purchase invoices for prompt payments. Thus, the credit discount has to be credited in a separate discount account and these have to be deducted from total purchases for the year.

7.2.3 Repair and Improvement (R&I) Costs [§16]

Repair implies restoration by either renewal or replacement of a subsidiary part of the whole. It is intended to preserve and maintain an already existing asset. Similarly, improvement means a valuable addition made to property or an emendation in its condition, amounting to more than simple repairs or replacement, costing labor or capital, and intended to make its value better, beautiful or utility or to adapt it for new or further purposes.

☐ Deduction of R&I Costs

In calculating a person's income for an income year from any business or investment, all costs incurred during the year in R&I of depreciable assets owned and used by the person during the year in generating income from the business or investment are deductible costs.

> **EXAMPLE 7-17** If a person incurred R&I cost but the asset which is repaired or improved is not owned by the person or not used during the year, the costs of R&I are not deductible.

☐ Limitation of R&I Costs

Deduction of R&I cost is allowed not exceeding seven percent of the depreciable base of a group of depreciable assets at the end of income year.

Table 7.2: Calculation of depreciable base

Depreciable base		Amount
Equals	The remaining amount after deducting depreciation for a particular pool at the end of preceding income year.	××
Plus	Costs incurred during the year including outgoing assets in or assets to a pool that is added to the base amount of depreciation of the pool.	××
Less	Any amounts derived from the disposal of any assets of the pool during that year	(×)
Depreciable base		××

☐ Treatment of Excess R&I Costs

Any excess costs for which a deduction is not allowed as a result of the limitation of the costs that are capitalized under pool to which relates depreciable base for the next year.

☐ Limitation Denied

The rule of seven percent of the depreciable base of the assets for the R&I cost during complete inspection is not imposed to air transportation service provider. The R&I costs incurred by the persons can be spent as prescribed by Nepal Civil Aviation Authority's rule[2].

EXAMPLE 7-18 A person disclosed the following particulars about his depreciable assets and R&I costs for the previous year. Ascertain the deductible R&I cost for the year.

Class / group	Net value from previous year	Purchase during the year	Disposal during the year	RI cost
A	1,200,000	300,000	200,000	100,000
B	600,000	150,000	100,000	50,000
C	150,000	75,000	50,000	5,000

The purchase of depreciable assets is made for Class A, B and C in Aswin, Falgun and Baishakh respectively.

Solution:

Depreciable base		A	B	C
Equals	Balance from previous year	1,200,000	600,000	150,000
Plus	Absorbed addition	300,000	100,000	25,000
Less	Disposal during the year	(200,000)	(100,000)	(50,000)
Depreciable base		1,300,000	600,000	125,000
Deduction of R&I costs				
Costs incurred during the year		100,000	50,000	5,000
7% of the depreciable base		91,000	42,000	8,750
Allowable R&I costs for the year		91,000	42,000	5,000

2 Inserted by the Finance Ordinance 2062 dated Srawan 1, 2062 and the Finance Act 2063 dated Srawan 1, 2063.

7.2.4 Deductible Reserve [§59(1)]

Please refer to chapter 5: (Special Provision for Insurance and Banking Industries)

7.2.5 Pollution Control (PC) Costs [§17]

ITA 2002 (p. 43) defines, "PC costs mean costs incurred by a person in the process that seeks to control pollution or protect and conserve the environment". The stated definition does not include the clear picture of PC costs. It is vague definition of costs. In simple, the term pollution means contamination of the environment by a variety of sources including but not limited to hazardous substances, organic wastes and toxic chemicals. The pollution is legally controlled and enforced through the state laws. According to Encarta (2004), control means limiting or restricting something or methods used in restricting something.

☐ **Deduction of PC Cost**

PC cost to the extent incurred by a person during the year in conducting the business is deductible. But, these are not deductible if incurred in conducting an investment.

☐ **Limitation of PC Costs**

Deduction of PC cost is granted with respect to all businesses conducted by the person and it is limited to 50 percent of the adjusted taxable income of that person. The adjusted taxable income of a person is calculated by not deducting donations, interest paid to tax exempt controlled entity, research and development (R& D) costs and PC costs.

☐ **Treatment of Excess PC Costs**

Excess PC cost of a person for which a deduction is not allowed as a result of limitation that is capitalized under pool "D" of the depreciable assets and it is depreciated according to law.

7.2.6 Research and Development (R&D) Costs [§18]

ITA 2002 defines, "R&D costs mean costs incurred by a person for the purpose of developing the person's business and improving business products or processes" (p. 43). The stated definition does not clear concept of R&D cost. In simple, R&D means an investigation of new or improved products. Thus, at least R&D costs should concern the following activities of investigation or improvement: R&D for tax purposes takes place when a business seeks to achieve an advance in science or technology; the activities which directly contribute to achieving this advance in science or technology through the resolution of scientific or technological uncertainty are R&D; certain qualifying

indirect activities related to the business are also R&D. Activities other than qualifying indirect activities which do not directly contribute to the resolution of the business's scientific or technological uncertainty are not R&D.

In 1987, Accounting and Auditing Standard Board (AASB) has mentioned the following elements as R&D costs.

(a) The cost of materials and services consumed in research and development activities;

(b) The salaries, wages and other related costs of personnel, to the extent that they are engaged in research and development activities;

(c) The depreciation of equipment and facilities to the extent that they are used for research and development activities;

(d) The amortization of other assets, such as patents and licenses, to the extent that they are related to research and development activities;

(e) Costs incurred for the company or group by other entities on research and development activities, and charged to the company or group; and

(f) Other costs that can be attributed to R&D activities and identified with specific projects.

☐ Deduction of R&D Costs

R&D costs to the extent incurred by a person during the year in conducting business are deductible costs. These may be deducted independently if not directly associated with a depreciable asset. If those costs are incurred in acquisition of improvement of an asset, they are agreed with under the general provisions applicable to costs of that type.

☐ Limitation of R&D Costs

Deduction of R&D cost is granted with respect to all businesses conducted by a person and it is limited upto 50 percent of the adjusted taxable income of that person. The adjusted taxable income of a person is calculated by not deducting donation, interest paid to tax exempt controlled entity, R&D and PC costs.

☐ Treatment of Excess Costs of R&D

Excess R&D cost of a person for which a deduction is not allowed as a result of limitation is capitalized under pool "D" of depreciable assets and it is depreciated according to law.

Table 7.3: Calculation of R&D and PC costs (in ordinary case)

Calculation of R&D and PC costs		Amount
Equals	Total of inclusions	×××
Deduction	General deduction Interest Cost of trading stock Costs of R&I Depreciation allowance	(×) (×) (×) (×) (×)
Adjusted taxable income		××
	50% of the adjusted taxable income	×
	PC costs incurred during the year	×
	R&D costs incurred during the year	×
Deductible:	PC costs R&D costs	× ×

If there is excess amount more than 50 percent of adjusted taxable income, the excess amount has to be capitalized under pool "D" according to Sc- 2 of depreciable assets.

Table 7.6: Calculation of PC and R&D costs in case where interest is paid to tax exempt controlled entity.

Calculation of pollution control costs		Amount
Equals	Total of inclusions (except interest income)	×××
Deduction	General deduction Cost of trading stock R&I costs Depreciation allowance	(×) (×) (×) (×)
Adjusted taxable income		×
	50% of the adjusted taxable income	×
	PC costs incurred during the year	×
	R&D costs incurred during the year	×
Deductible: PC costs or R&D costs		×

If Pc or R&D costs of the year excesses 50 percent of adjusted taxable income, the excess amount has to capitalize under pool 'D' according to Sc- 2 of depreciable assets. In the future year, it is depreciated by 15 percent.

EXAMPLE 7-19 An entity presents the following Income Statement for the previous year. You are required to calculate R&D and PC costs.

Particulars	Amount	Particulars	Amount
Opening balance	50,000	Sales	2800,000
Purchase	1,500,000	Interest income	50,000
Freight & insurance	25,000	Net gain from disposal	
Wages	450,000	of business assets	300,000
Staff salary	250,000	Compensation	200,000
R&I costs	60,000	Closing stock	95,000
Depreciation	80,000		
Office expenses	60,000		
PC costs	500,000		
Interest	160,000		
R&D cost	150,000		
Net profit	60,000		
	3,445,000		3,445,000

Additional information:

1. Purchase includes purchase of computer Rs. 20,000
2. Office operation expenses includes penalty paid to the Government of Nepal Rs. 5,000
3. Twenty-five percent of interest was paid to an individual and rest deposited in a bank.

Solution:

Calculation of profit and gains from business for the income year 2062/063

INCLUSIONS		Amount	Amount
1	Amount derived from disposal of trading stock	2800,000	
2	Income from investment that is directly connected with business	50,000	
3	Net gain from disposal of business assets	300,000	
4	Amount of compensation	200,000	
Total of inclusions		3,350,000	3,350,000
DEDUCTIONS:			
1	General deduction	305,000	
2	Cost of trading stock	1,910,000	
3	Interest	160,000	
4	R&I cost	60,000	

5	Depreciation allowances	80,000	2,515,000
Adjusted taxable income			835,000
	50% of adjusted taxable income		417,500
	Debited PC costs		500,000
	Debited R&D costs		150,000
Thus,	**Deduction for the year:**		
	PC costs		417,500
	R&D costs		150,000

Hence, in this situation, costs of R&D and PC are deductible Rs. 150,000 and Rs. 417,500 respectively from the business income. The excess amount of PC cost Rs. 82,500 is to capitalize in pool "D" of depreciable assets as an unabsorbed cost. The unabsorbed costs are added on depreciated value of the assets in respective pool for the next year.

EXAMPLE 7-20 The following is the Income Statement of Himal Company. Calculate allowable interest for the relevant income year.

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Sales	4,200,000
Purchase	2,445,000	Interest income	128,000
Freight & insurance	260,000	Compensations	50,000
General expenses	290,000	Closing stock	100,000
Interest	650,000		
Depreciation	105,000		
R&I costs	78,000		
R&D costs	550,000		
Net profit	50,000		
	4,478,000		4,478,000

Additional information:

1. Himal Company is controlled by tax-exempt organization.
2. Interest income, which is shown in income statement, was received from individual including financial institution Rs. 50,000. It is already a grossing up amount according to current law on tax credit.
3. The debited interest of income statement is paid to tax exempt controlled entity.

Solution:

	Adjusted taxable income	Amount	Amount
Equals	Total inclusions excluding interest income		4,250,000
Less	General deduction	290,000	
	Cost of trading stock	2,655,000	
	R&I costs	78,000	

	Depreciation allowances	105,000	3,128,000
Adjusted taxable income			1,122,000
	50% of the adjusted taxable income		561,000
	Debited R&D cost		550,000
	Debited PC cost		0
Thus, whole debited amount of research and development cost is deducted from business income.			

Therefore, in this context, the allowable R&D cost for deduction is Rs. 550,000. The excess cost incurred during the year in R&D is to be capitalized in pool "D" of depreciable assets.

7.2.7 Depreciation

For calculating a person's income for an income year from the business or investment, deduction of depreciation is allowed as prescribed rate of depreciable assets owned and used by the person during the year in the production of the person's income from the business or investment. The IRD instructs that the depreciation allowance of not owned or unused depreciable assets for the income year is not allowable[3].

In simple, GAAP allows a depreciation deduction as a reasonable allowance for the exhaustion, wear and tear including a reasonable allowance for obsolescence of property used in a trade or business and of property held for the production of income by a taxpayer. Deduction of depreciation is not available other than depreciable assets.

☐ **Concept of Depreciation**

Depreciable asset is one among various types of assets. It may be both tangible and intangible. When a depreciable asset such as building, plant, machinery, equipment furniture, software etc. is purchased, the cost of that asset is not spent immediately in the year it was purchased. The reason is that the asset will benefit the purchaser for years to come, not just in the year it was purchased. Value or amount of depreciation is significant to match the cost of an asset with benefit that the asset bestows upon its owner. For instance, if the cost of new asset entirely spent in the first year but it is used for the next fifteen years, the income in those years would not accurately reflect the profits made through use of this asset. It is a hypothesis only. In real cases, this event is quite irrelevant. It earns income when used in subsequent year. Thus, Taccone (n.d.) summarizes depreciation in following points.

[3] Instructed by the circular No. 2062/063 dated Ashadh 16, 2063 (policy section) of the IRD.

- Depreciation is a process of allocating expense on cost of a plant asset over its useful (service) life in a rational and systematic manner.
- Cost allocation is designed to provide proper matching of expenses with revenues in accordance with the matching principle.
- During an asset's life, its usefulness may decline because of wear and tear or obsolescence.
- Recognition of depreciation does not result in accumulation of cash for replacement of an asset.
- Land is the only asset that is not depreciated.

Depreciation is also closely related with amortization. The amortization is the process of writing off the cost of an asset. In a piece of equipment, the word used is 'depreciation', which is simply a type of amortization, where the cost of the equipment is gradually written off over a number of years. In case of a bank loan, a fee charged by bank while taking loan is usually amortized over the life of loan and it is called amortization.

☐ Factors Effecting the Computation of Depreciation

Three factors that affect the computation of depreciation are:

- Cost: all expenditures necessary to acquire the asset and make it ready for intended use.
- Useful life: estimate of expected life based on need for repair, service life, and vulnerability to obsolescence.
- Salvage value: estimate of an asset's value at the end of its useful life.

☐ Method of Depreciation

The most useable methods of depreciation are as follows:

1. Straight-line: The straight-line depreciation is calculated equal to depreciable cost over useful life of the depreciable assets as given below:

Depreciable cost		×
Equal	Cost of the depreciable assets	××
Less	Salvage value of the depreciable assets	(×)
Depreciation allowance:		×
Equals	Depreciable cost	××
Divide by	Useful life of the depreciable assets	×

2. Units of activity: The depreciation allowance under the units of activity is calculated:

- The total units of activity for entire useful life are estimated,

- The amount is divided into depreciable cost to determine depreciation cost per unit, and
- The depreciation cost per unit is then applied to units of activity during the year to determine annual depreciation.

3. Declining balance: Declining balance method of depreciation is too easy method of depreciation in comparison to other method of depreciation. Most of the least developed countries adopt this method of depreciation. It may be justified by following additional points.

- Salvage value is ignored in determining the amount to which the declining balance rate is applied.
- Annual depreciation rate is applied to depreciable book value of depreciable asset at the end of the period.

Depreciation allowance is reduced from income of a person. Since, it also affects size of the taxable income and tax amounts simultaneously. According to ITA 2002, the depreciation allowances are granted for depreciable assets to accept the wasting character of assets. Amount of depreciation allowance is based on depreciable base of assets, which is held at the end of each year. In addition, the depreciable base has to satisfy the following rule of thumb.

☐ Validation

Validation bases on an act, deed, will, and the like, which has received all formalities required by law. The depreciation allowance requires the following validations.

1. Own and use of assets [§19(1)]: Costs incurred to acquire the depreciable assets used in economic activities and owned by the person are the basis to grant depreciation. Thus, depreciable assets must be owned and must be used to receive or earn income from business or investment.

Usually, the depreciable base is equal to asset's purchase price minus any discounts and plus any sales taxes, delivery charges, and installation fees if other things such as duration to acquire remaining the same.

EXAMPLE 7-21 A person bought machine. Invoice price of the machine was Rs. 2,000. He paid 10 percent custom charge, and delivery cost Rs. 400. The depreciable base of the machine would be Rs. 2,600 and that is the maximum amount the person could claim as depreciation over the life of the asset.

EXAMPLE 7-22 If a person purchased and owned a vehicle in an income year to transport its clients but the person did not use vehicle during the year, he is not granted any depreciation allowance for that year. Again, it is not available until it is not used.

EXAMPLE 7-23 If a person is going to acquire a vehicle for forthcoming year but he is using this vehicle during the year. The vehicle is neither owned by him nor paid its cost. Because it is not owned and price not paid, he could not get any depreciation allowance for this vehicle.

2. Depreciation for construction of public infrastructure [§19(2)]**:** Depreciation allowances for plants, equipment and other machinery installed in electricity projects to build power stations, generate and transmit electricity and in the projects conducted by any entity to construct and operate public infrastructure and transfer it to the Government of Nepal include following requirements.

> **(a) Provision for residual value of old assets** [§19(2)(a)]**:** If old plants, equipment and other machineries that are already installed require replacement in any income year due to damage or being too old, the balance value of old plants, equipment and other machineries after subtracting the depreciation up to the year from their initial costs, are allowed as expenses for deduction.

EXAMPLE 7-24 An entity, having involved in hydroelectricity project if replaced its ten years old turbine which comprises residual value after depreciation for the year Rs. 2 million. In this context, this residual value of old turbine is allowed as expense for deduction.

> **(b) Deduction of balance value of other assets** [§19(2)(b)]**:** At the time of transfer of other assets (except old assets replaced in accordance with plants, equipment and other machinery) to the Government of Nepal, the balance value after subtracting depreciation up to the year of transfer from their costs is allowed as expense for deduction.

EXAMPLE 7-25 An entity that was engaged to construct road is going to handover the project. However, it has some value of other assets after subtraction of depreciation from its original value. In this context, according to law, the value is granted as expense for deduction from the income.

☐ Classification and Pooling [Sc. 2(1)]

Depreciable assets are grouped into five classifications and pooling. These classifications of the depreciable assets are nearly based on similarity in purpose, nature and durability.

Table 7.4: Classification and pooling of depreciable assets

Classes	Assets included
A	Building, structures, and similar construction of permanent nature[4].
B	Computers, data handling equipment, fixture, furniture, and office equipment.
C	Automobiles, buses, and minibuses.
D	Construction and earth-moving equipment[5] and any other depreciable assets, which are not included in other classes including those excess amounts of pollution control costs and research and development costs.
E	Intangible assets other than depreciable assets included in class 'D'

Depreciable asset includes both tangible and intangible assets. As mentioned in the above table, there are two types of depreciable assets such as class A, B, C and partial items of class D are tangible depreciable assets and class E and partial items of class D are intangible depreciable assets.

☐ Determination of Group or Pool [Sc. 2(1)]

Depreciable assets subject to depreciation allowance are grouped into asset categories based on types of asset and are depreciated using rates provided accordingly. This method of depreciating assets is expressed as “pooling” method since the depreciable assets are segregated into “pools” or “groups”. The depreciation allowances are determined for each group rather than for each individual asset within the prescribed group. Each depreciable asset owned and used by a person in person's income generation from a particular business or investment ought to be determined in a pool. This determination of pool is considered person's pools of depreciable assets and that depends on time that the asset is first

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[4] ITA 2002 has not defined the terms ‘structure’ and ‘similar construction of permanent nature’. In simple, structure and similar construction of permanent nature refers works with a long economic life, such as roads, railway tracks, power transmission lines or pipelines.

[5] Primary earth-moving equipment/machines are the heavy-duty tractor, bulldozer, scrapers, and excavators etc. which are used for constructing works.

owned or used. The following are decisive factors to maintain the pool of a person.

1. **Equitable and adjustable classification:** Depreciable assets of classes A, B, C, or D must be placed with all other assets of same class owned and used by a person in that business or investment.

EXAMPLE 7-26 A person has been operating a trekking business. It has many types of equipment related to trekking such as tents, utensils, ice shake, rope etc. In this context, the classification of depreciable assets permits only class D. In subsequent year if the person purchased additional depreciable assets of similar nature that has to be grouped into class D.

2. **Segregation of depreciable assets from same class:** In case of class E, the depreciable asset should be placed under separate pool of each asset even if they are of same class.

EXAMPLE 7-27 In a year, a person acquired computer software and placed it to class E. In subsequent year, the person acquired patent right for 5 years. These both were for 5 years. However, these intangible assets could not be placed in same pool but it can be placed in same class.

3. **Costs of excavation is placed under assets acquiring costs:** The expenses incurred by a person in relation to excavation of natural resources and extraction and development of mineral resources is treated as cost incurred in acquiring assets for business that is related to this income.

EXAMPLE 7-28 A business is involved to produce 'A' natural resource. In the process of receiving 'A' natural resources, it found another natural resource such as 'B'. The cost incurred to excavate product 'B' is treated as asset acquiring cost.

☐ Determination of Depreciable Base [Sc. 2(2)]

The base amount of depreciation of depreciable assets in classes "A, B, C, D" and "E" at the end of an income-year should be ascertained by adopting prescribed rules. But, it does not fall below zero.

Table 7.5: Calculation of depreciable base

Depreciable base	***Classes A, B, C and D***	***Class E***
Equals	The remaining amount after deducting depreciation for a particular pool at the end of	The depreciation basis of the pool at the end of preceding income year, if any.

	preceding income year.	
Plus	Costs incurred during the year including outgoing assets in or assets to a pool that is added to the base amount of depreciation of the pool.	Amount added to the depreciation base of the pool during the year as per rules applicable with respect to outgoing assets within the pool.
Less	Any amounts derived from disposal of any assets of the pool during that year	
Result	Depreciable base of A, B, C and D for the year	Depreciable base of "E" for the year

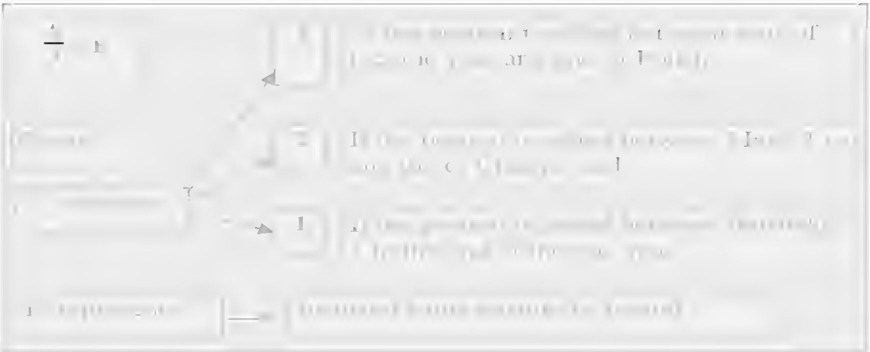
The depreciable base of class A, B, C and D is calculated by subtracting disposal during the year from balance and addition during the year including balance from previous year while the depreciable base for the class "E" is obtained from balance from previous year plus addition during the year.

☐ **Determination of Costs for Additions** [Sc. 2(2)]

Especially the depreciable assets, which are acquired during the year, those will not be used for whole year. Due to this, it needs adjustments for depreciation allowances. Generally, there are three methods of adjustments: time adjustment, rate adjustment and cost adjustment. ITA 2002, adopts the last method i.e., cost adjustment. The costs that are incurred in outgoing for a depreciable asset included in a person's pools of depreciable assets should be added to the depreciation basis of the person's relevant pool as follows:

The first portion is added at whichever time is later between the time the asset is added to the pool in accordance with the classification and the cost is incurred, and calculated in accordance with the following formula:

Figure 7.3: Cost of additions



EXAMPLE 7-29 A person acquired class 'C' depreciable assets in Poush, Chaitra, and Ashadh at the costs of Rs. 10,000; 30,000 and 60,000 respectively. The cost of addition for the year is Rs. 50,000 out of total cost Rs. 100,000. These are calculated as given below:

Table 7.6: Cost segregation for absorbed additions

Acquired cost	Added on	Value of A	Absorbed Additions	Unabsorbed portion
Rs. 10,000	Poush	3	3/3 × 10,000= Rs.10,000	No unabsorbed
Rs. 30,000	Chaitra	2	2/3 × 30,000= Rs. 20,000	Rs. 10,000
Rs. 60,000	Ashadh	1	1/3 × 60,000= Rs. 20,000	Rs. 40,000
		Total	Rs. 50,000	Rs. 50,000

☐ Treatment of Unabsorbed Portion of Cost

Unabsorbed portions of the costs are included in depreciable base for next year. Thus, unabsorbed portions of costs can be included after calculation of depreciation allowance.

Table 7.7: Treatment of absorbed and unabsorbed additions

Equals	1	Net value from previous year	-
Plus	2	Absorbed addition	50,000
Less	3	Disposal during the year	-
	4	Depreciable base	50,000

Calculation of depreciation allowance

Equals	4	Depreciable base	50,000
multiplier	5	Depreciation rate	20%
	6	Depreciation allowance	10,000

Calculation of depreciated value

Equals	4	Depreciable base	
Less	6	Depreciation allowance	

	7	Net value after depreciation	40,000

Opening value for next year

Equals	7	Net value after depreciation	40,000
Plus	8	Unabsorbed additions	50,000
Plus	9	Capitalized of R&I cost	-
Plus	10	Capitalized of PC cost	-
Plus	11	Capitalized of R&D cost	-
	12	Net value for next year	90,000

❑ Residual Value Write Off

The residual value of an asset is often insignificant and can be ignored in calculation of depreciable amount. The depreciable base of pool of depreciable assets in classes A, B, C, or D at the end of an income-year after deduction of depreciation if results an amount that is less than Rs. 2,000; the whole of the remaining amount is calculated as additional depreciation.

> **EXAMPLE 7-30** The depreciable base of depreciable assets of class B at the end of year is Rs. 2,400 and depreciation rate of class B is 25 percent per annum. When a person calculates its depreciation, it results Rs. 600 for depreciation and Rs. 1,800 for depreciated value. Thus, in this situation a person has to reduce whole amount for depreciation.

❑ Depreciable Base

Depreciable base of depreciable assets of a person is calculated as given below:

Net balance from the previous year		×
Add:	Absorbed additions during the year	××
Less:	Disposal during the year	×
Depreciable base for the year		××

Disposal value of a depreciable asset plays vital role to obtain base value of the depreciable asset. It will be described in the following sub-points, disposal of depreciable assets.

❑ Depreciation

Depreciation expense is a significant component of total expenses. It is obtained from depreciable base by multiplying depreciation rate. The depreciation rates are prescribed by the law.

EXAMPLE 7-31 A depreciable base of a pool "A" of depreciable asset of a person is Rs. 100,000 and its depreciation rate as prescribed by law is 5 percent. In this context, depreciation of that person is (5 percent of Rs. 100,000) Rs. 5,000.

☐ Rates of Depreciation [sc-2(3)]

Depreciable assets, which are owned by a person and used for earning or receiving income, are considered as scratched, weaned and depreciated from durability and life expectancy. To maintain market value of depreciable assets; those are depreciated by using depreciation rate. The depreciation rates are fixed by using modeling. These are of three types such as historical base, capital expenditure base, and estimation of capital expenditure base. In Nepal, tax law fixes depreciation rates however; it does not specify the base of the depreciation rate.

Table 7.8: Rates of depreciation

Classes	A	B	C	D	E
Rates of depreciation	5%	25%	20%	15%	The percentile rate rounded down to nearest half year after dividing cost incurred at the time of purchase of an asset by period of its use.

☐ Addition of one-third Bonus on Depreciation Rates [sc. 2(3)]

Addition of one-third bonus on depreciation rate is applied to depreciation of plants, equipment and other machinery installed if the entities that are involved in building power stations, generation and transmission of electricity and project conducted by any entity in constructing and operating public infrastructure and transfer it to the Government of Nepal are granted separate depreciation rate. The depreciation rate of plants, equipment and other machinery installed by those projects are fixed additional one third on the depreciation rate otherwise applicable.

☐ Disposal of Depreciable Assets

A person when calculates income from disposal of depreciable assets used during that income year and if incoming amount exceeds outgoing, the excess shall be included in calculating income from business or investment in which assets are used.

Table 7.9: Calculation of income from disposal of depreciable assets

Income from disposal of depreciable assets equals to:		**Amount**
Income (+)	**(A) Incoming** A person's incoming derived during an income-year from disposal of depreciable assets that were in the person's pools of assets classes A, B, C, or D during the year.	×××
Costs (outgoing) (-)	**(B) Costs (outgoing less depreciation)** The depreciation base of pool at the end of year calculated as per section 2(3) of depreciation schedule without including income from disposal.	(××)
Income (if +)	Income from disposal of depreciable assets	×

EXAMPLE 7-32 A depreciable base value of a pool of a person is Rs. 24,000. He disposed it at Rs. 30,000. In this context, his income from business is Rs. 6,000 if there is no other depreciable asset on the pool.

☐ Dissolution of Pool

If a person disposes all assets in a pool of depreciable assets before the end of an income-year, the pool is treated as dissolved and the following principles are adopted.

Table 7.10: Calculation of results of dissolution

A	**Incomings**	**Amounts**
	A person's incoming either derived or to be derived from the disposal during the year	×××
B	**Costs (Outgoings)**	
The sum of following three:		
1	The written value of pool during the year,	(×)
2	Outgoings added to depreciation basis of pool during the year; and	(×)
3	Outgoings to be added to depreciation basis of pool during the following income-year [§ 2(5)]	(×)
(+)	Excess received is treated as an income (positive result of A-B)	××
(-)	Shortage received is treated as a depreciation (negative result of A-B)	(××)

CASES AND SOLUIONS

A balance sheet of "A" Company shows following transactions about depreciable assets during previous year. Ascertain depreciated value for the year, depreciation for the year and net gain from disposal of depreciable assets.

Opening balance from previous year

Class	Value from previous year	Purchase during the year on:		Disposal during the year	Repair and improvement costs incurred more than 7% during the year
A	5,150,000	5/15/20xx	250,000	140,000	40,000
B	650,000	10/15/20xx	90,000	40,000	-
C	2,000,000	01/30/20xx	180,000	2,400,000	35,000
D	400,000	03/13/20xx	6,000	-	16,000

Additional information:

1. 25% of repair and improvement costs of class 'A' were incurred for disposed building.
2. The cost of sold vehicle was only Rs. 1,800,000.

Solution:

Calculation of depreciation allowance of "A" Company for the income year 2063/064.

Classes and groups of assets	A Building and permanent structure	B Furniture, fixture and equip.	C (Vehicles) buses and minibuses	D Machinery and earth moving equipment and others	Total
Opening balance	5,150,000	650,000	2,000,000	400,000	8,200,000
Absorbed additions	250,000	60,000	60,000	2,000	372,000
Disposal	(140,000)	(40,000)	(2,215,000)	-	(2395,000)
Depreciable base	5,260,000	670,000	-	402,000	6,332,000
Depreciation rate	5	25	20	15	
Depreciation	263,000	167,500	-	60,300	490,800
Depreciated value	4,997,000	502,500	-	341,700	5,841,200
Addition:					
Unabsorbed additions.	-	30,000	120,000	4,000	154,000
Capitalization:					
R&I costs	40,000	-	35,000	16,000	91,000
PC costs	-	-	-	-	-
R&D costs	-	-	-	-	-
Balance for the next year	5,037,000	532,500	-	361,700	5,931,200

Clarification:

1. The depreciated value for the year is Rs. 5,931,200.
2. The depreciation allowance for the year is 490,800.
3. The net gain from disposal of depreciable assets is Rs. (2,400,000-2,215,000) 185,000. This amount is shown in the inclusion named as net gain from disposal of depreciable assets.

Working note:

1. Calculation of additions and remaining portion of acquisition

Class	Acquired cost	Added on	Formula: A/3xB	Absorbed addition	Unabsorbed addition
A	250,000	On 5/15/20xx	3/3 × 250,000	250,000	No remaining
B	90,000	On 10/15/20xx	2/3 × 90,000	60,000	30,000
C	180,000	On 01/30/20xx	1/3 × 180,000	60,000	120,000
D	6,000	On 03/13/20xx	1/3 × 6,000	2,000	4,000
Total	526,000			372,000	154,000

REVIEW QUESTIONS AND CASES

1. What is general deduction? What are the main requirements of general deduction? Explain with examples.
2. Demurrage is neither fine nor penalty. But tax law does not allow deduction of demurrage. Explain.
3. "Capitalizations of some specific deduction denotes to cost." Explain briefly.
4. "Interest plays role of either expense or cost in deduction. Illustrate this statement.
5. What are the main requirements of interest deduction?
6. What is matching principles? Write down its significance to get real profit of business.
7. Why cost of trading stock is a crucial element? Write down its method of determination.
8. "FIFO method is an ultimate tool to determine value of closing stock." Illustrate this statement.
9. What is R&I cost? Why it is kept in specific deduction? Explain with examples.

10. What is R&D and PC costs? Write down treatment of excess R&D and PC costs.
11. What is depreciation? Explain with suitable examples.
12. Critically examine state of depreciation in case if you apply cash flow taxation.
13. "Straight line method of depreciation is more beneficial for newly established company." Critically examine this statement.
14. Can play depreciation in tax planning? Examine the provisions of laid down in the ITA 2002.
15. The following is Income Statement of Nepal Company for the previous year.

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Sales	4,200,000
Purchase	2,445,000	Interest income	128,000
Freight	260,000	Compensations	50,000
General expenses	290,000	Closing stock	100,000
Interest	680,000		
Depreciation	105,000		
Costs of R&I	78,000		
Costs of R&D	550,000		
Net profit	20,000		
	4,478,000		4,478,000

Additional information:

1. Nepal Company is controlled by tax exempt organization.
2. Interest income which is shown in income statement is received from individual including financial institution.
3. The whole amount of interest was paid to controlled entity.

You are required to calculate deductible interest amount.

16. Mr. Ghiraiya, a businessperson disclosed the following details of income statement of his business for the previous year.

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Sales	1,090,000
Purchase	1,000,000	Compensation	125,000
Custom duty	15,000	Closing stock	127,000
Delivery costs	30,000		
R&I costs	20,000		
Salary	168,000		
Printing and stationery	9,000		

Net profit	50,000		
	1,342,000		1,342,000

Additional information:
1. Opening and closing stocks are under and overvalued by 5 %.
2. Purchase return Rs. 25,000 is not deducted from purchase account.
3. Custom duty includes firm's renewal charge Rs. 5,000.
4. Additional delivery costs Rs. 15,000 is not included in above statement.
5. Purchase includes purchase of computer Rs. 100,000

You are required to calculate cost of trading stock for the relevant year:

17. A person disclosed the following particulars about his depreciable assets and R&I costs for the previous year.

Class / group	Net value from previous year	Purchase during the year	Disposal during the year	R&I cost
A	1,200,000	300,000	200,000	100,000
B	600,000	150,000	100,000	50,000
C	150,000	75,000	50,000	5,000

Additional information:

Depreciable assets of the class A, B, and C were purchased in Aswin, Falgun and Baishakh respectively.

Required:

(a) Total deductible amount of depreciation

(b) Total deductible amount of R&I costs

18. A Company provided the following details about its fixed assets for the previous year.

Class / group	Net value from previous year	Purchase during the year	Disposal during the year	R&I cost
A	5,000,000	450,000	980,000	-
B	650,900	106,000	13,000	80,000
D	1,350,000	401,000	226,000	-

Additional information:
1. The actual book value of the sold building was Rs. 680,000.
2. The excess amount of pollution control cost is Rs. 20,500.
3. The purchased date of A, B and D were on Ashadh, Chaitra and Magh 1, of the previous year.

Required:

(a) Depreciable base of each group [2]

(b) Amount of total depreciation [2]

(c) Net value for the next year. [2]

19. M/S "X" company disclosed the following details of his depreciable assets. You are required to compute depreciable value showing each class.

Opening balance of each class was:

Class	A	Rs. 500,000	Class	B	Rs. 350,000
Class	C	Rs. 850,000	Class	D	Rs. 395,000
Class	E	Rs. 150,000			

Acquisitions during the year

- On Bhadra 1; land, building, furniture, fixture and office equipment of Rs. 150,000; 210,000 and Rs. 60,000 respectively.
- On Poush 1; computer and refrigerator of Rs, 50,000 and Rs. 100,000 respectively.
- On Chaitra 15; computer software and patent rights of Rs. 25,000 and 15,000 respectively.
- On Jestha 15; vehicles, bulldozer, tent, and typewriter of Rs. 450,000; Rs. 2,050,000; Rs. 15,000 and Rs. 24,000 respectively.

20. A person disclosed the following particulars about his state of assets. You are required to calculate depreciable base, depreciated value of assets, depreciation allowances and net value for the next year's opening balance.

Particulars	Land	A	B	C	D	E
Opening balance	250,000	850,000	650,000	950,000	350,000	150,000
Additions on Bhadra	200,000	-	25,000	-	50,000	-
Additions in Magh	150,000	150,000	330,000	-	-	150,000
Additions in Chaitra	15,000	30,000	45,000	27,000	30,000	60,000
Additions in Ashadh	30,000	-	-	150,000	45,000	-
Disposal during the year	250,000	35,000	95,000	13,000	28,000	-

Additional information:

1. Value of disposal assets of land, class A, B, C and D were Rs. 150,000; Rs. 40,000; Rs. 90,000; Rs. 25,000 and Rs. 14,000 respectively.
2. The person removed assets Rs. 15,000 from class B, its actual market price was Rs. 35,000. However, it is not included in disposed value.

21. Balance Sheet of a Limited Company of previous year showed depreciated value of its asset grouped under D Rs. 650,000. During

that year the company added two items of this group: one of Rs. 100,000 on Kartik, and another of Rs. 150,000 on Baishak. Moreover, the company disposed off one of its asset with book value of Rs. 50,000 on operating date and original value of Rs. 75,000 at Rs. 80,000.

Required:

(a) Depreciated value of asset at closing.
(b) Current amount of depreciation.
(c) Capital gain on the deal. [3+2+1] [MBS, 2060, TU]

22. As shown by balance sheet of a Ltd. company in previous year, the depreciated value of its assets grouped under C was Rs. 1,500,000 during the year. The company added two more assets of this group: on Bhadra Rs. 500,000 and another on Falgun Rs. 600,000. The company disposed off one asset with book value of Rs. 100,000 on opening date at Rs. 125,000.

Required:

(a) Current amount of depreciation to be charged.
(b) Depreciation based asset of closing. [4+2] [MBS, 2061, TU]

Chapter 8

Deductions that are Not Allowed

8.1 CONCEPT OF NOT ALLOWED DEDUCTIONS

ITA 2002 itemizes expressly disallowed expenses for deduction while computing taxable income of a person. In general, expenses represent the amount spent by persons for different purposes, which they claim to deduct from their incomes in order to arrive at the taxable income. However, this sort of claims is not always accepted due to the clear expression by the income tax law that there are certain expenses which are not permitted. The law expresses as "notwithstanding anything contained in this Act, for the purpose of calculating a person's income for an income year from any business, employment and investment, no

deduction is allowed". Thus, the expenses, which are of following nature, are expressly disallowed for deduction while computing the taxable income.

8.1.1 Expenses of Personal and Domestic Nature [§21(1)(a)]

If persons spend money for their personal consumption to satisfy their personal needs, these expenses are not deductible from any of the income heads: employment, investment or business.

☐ Personal Expenses Incurred by an Individual

Personal expenses incurred by an individual and the following expenses, including interest incurred with respect to money borrowed to the extent to which it is used, for personal purpose are denied for deduction.

1. **Interest on personal loan:** Interest incurred with respect to money borrowed to the extent to which it is used for personal purpose is not deductible amount.

   EXAMPLE 8-1 If a person borrows money, uses 70 percent in business and 30 percent personal purposes, the person can deduct only 70 percent of the interest from business income. The interest of personal purposes is not deductible from business or investment income.

2. **Expenses incurred on behalf of an individual:** Expenses incurred on behalf of an individual including expenses for shelter as well as meals, refreshment, entertainment and other leisure activities are not deductible amounts.

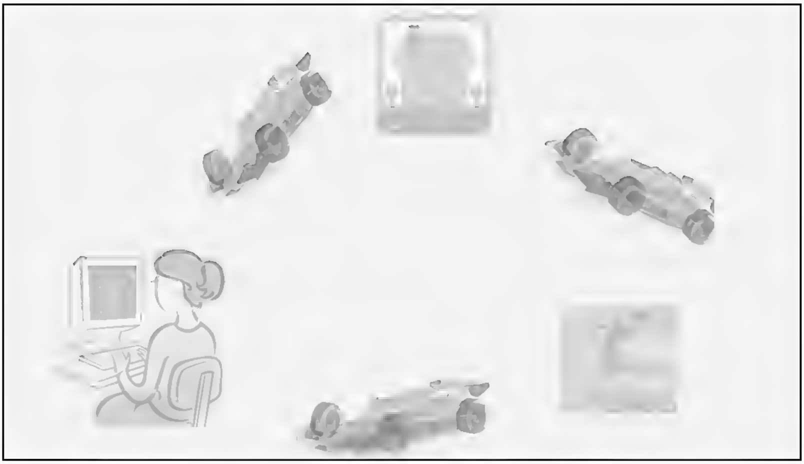
   EXAMPLE 8-2 An owner of a business organization ordered to a hotel for dinner, refreshment, entertainment and shelter for his relatives. Hotel invoiced to the business organization and paid it accordingly. The payments are observed as personal nature on behalf of an individual; including meals, refreshment, entertainment and shelter and these are not deductible.

3. **Expenses incurred on individual commuting:** If commuting charge is connected in due course of a business or investment the costs of commuting are deductible from the respective business or investment income with which the commuting is allied. However, even if in such a case the commuting costs are deductible, the deductibility does not include cost for commuting between the individual's home and a place at which the business or investment is operated because this is in each case a private activity.

EXAMPLE 8-3 A businessperson, dweller of place "DP" has been operating his business in place "BP". His daily routine works are: at 7 in the morning, he reaches at work place by microbus at which his business hour starts at 10 in the morning he gets back to place "DP", using taxi to purchase the goods for business and backs to place "BP" by using taxi. At 5 in the afternoon he closes the business and goes back to the dwelling place "DP". In this case, the commuting of taxi is deductible while microbus is non-deductible from his business income.

EXAMPLE 8-4 Refer back to Example 8-3, if the person purchases required goods from place "DP" at 7 in the morning and moves to place "BP" using microbus or taxi taking goods, the commuting charge is deductible from his business income.

EXAMPLE 8-5 A person moved by taxi to creditor's place "CP" from his business place "BP" to collect debts. After finishing his work he moved to his dwelling, place "DP" for lunch and goes back to business place "BP" for accounting his debtors. In this condition, the deductible commuting charges are only "BP" to "CP" and "CP" to "BP".



4. Clothing expenses of outside work: If the clothes are only appropriate to wear at work-places the costs to purchase those clothes may be deducted. The expenses to acquire private clothing, to an individual owner, which are suitable for wearing outside work-place, are non-deductible.

EXAMPLE 8-6 A nurse uses apron in workplace to keep her clean during working. It is a cost of employer. In an income year, employer acquired a coat instead of apron which is useable for outside work and she wears accordingly. In this situation, the acquisition cost instead of apron, which looks like a coat and useable frequently outside work is personal clothing and it falls under non-deductible from business income.

5. Education expenses of scholarly qualified degree: If the education is directly relevant to a business or investment conducted by the individual and the education and training does not lead to a general scholarly qualified degree or diploma but has a link to the business or investment, the expenses for training or education are deductible. But, if expenses are made for education and training of an individual owner for scholarly qualified degree and those are not relevant to the business or investment, these expenses are non-deductible.

EXAMPLE 8-7 A welder operates a welding business. In an income year, he attended two training: iron window designing and marketing of iron products spending Rs 10,000 and Rs. 5,000 respectively. These trainings are directly related to his business and help to increase sales in future. Thus, costs of trainings are deductible from his business income.

EXAMPLE 8-8 If a welder joined a campus to study at bachelor's degree level in mathematics and spent Rs. 9,000, these educational costs are non-deductible from his business income due to its irrelevancy to the business and incurred for scholarly qualified bachelor degree.

☐ Costs Incurred by another Person in Respect of an Individual [§21(1)(a) (2)]

When a person makes a payment to an individual, costs incurred in making the payment, including expenses incurred in part of a third person, apart from and to the extent of the following conditions are also denied for deduction.

1. If the payment is included in calculating individual's income: Whether or not the payment is included in calculating the individual's income will depend on whether the payment is sufficiently connected with an earning activity of the individual that the payment has received. In other words, if the payment constitutes income from employment, business or investment for

the individual the other person may deduct this payment from his taxable income.

EXAMPLE 8-9 An employee received benefits from employer: provision of in-house meals and refreshments. But, the employee did not include these received benefits in calculating his income from employment. In this context, no deduction allowed to the employer for costs incurred in making the payment.

EXAMPLE 8-10 Refer back to example 8-9, if the payment of benefits is included in calculating employee's income however, payments may be non-deductible due to the irrelevancy in production of income from business or investment (§13).

EXAMPLE 8-11 Assume that if payments are included in calculating the employee's income and that is incurred in the production of income from business or investment, they are deductible.

2. If an individual makes a return payment of an equal market value: If an individual makes a return payment of an equal market value to the person considering the first-mentioned payment, the cost is treated as allowable deduction.

EXAMPLE 8-12 A restaurant business owner provides a meal at a restaurant to an individual and receives a payment in return and shows income from disposal of trading stock. In this condition, the owner uses the matching principles. Thus, cost of goods sold is deductible amount from the income from business.

EXAMPLE 8-13 Refer back to example 8-12, the same restaurant owner if provides free meal to a relative or family member, he must not deduct the costs incurred for the provision of free of charge meal as he do not receive any taxable payment from the relative in return for the provision of the meal.

3. If the payments are so small and impractical to keep accounts: The payment consists of amounts that are so small and thus unreasonable or very difficult or administratively impracticable to keep accounts and satisfies the following conditions.

- Where the payment is made for tea, stationery, awards, emergency aid or payment for similar other provisions approved by the IRD
- Where the payment is administratively impractical to keep account separately in the name of payee

- Where the payment does not exceed Rs. 500 at one time of payment

EXAMPLE 8-13 In an income year, an employer provides a diary Rs. 150, taxi fare Rs. 60 and meal Rs. 90 to his employees. These benefits are not included in the income of the employees. However, these costs are deductible from the business income.

8.1.2 Amounts of Income Tax, Fines and Penalties [§21(1)(b)]

Any amounts of income tax or fine paid or payable under the ITA 2002 are non-deductible. In addition, if the taxpayer has been imposed with fines or penalties these amounts must not reduce the taxable income. Fine and penalties also include similar amounts paid in respect of the breach of any kind of law or bylaw in Nepal or in a foreign country. If the taxpayer has been fined by a public authority for whatever reason in whichever country he is not allowed to deduct these penalties from his taxable income.

EXAMPLE 8-14 An income statement of a Company includes: amounts of income tax including fine and penalty paid to the Government of Nepal, penalties paid to local government, VAT and excise duty paid to the Government of Nepal. In this context, only one item of custom duty becomes deductible. In case of VAT, that can be deducted if its turnover is below than threshold and the person is non-VAT register.

These fines or penalties also include the following amounts.

- Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
- Paid as a penalty imposed by central or local law in a civil action.
- Paid in settlement of actual or possible liability for a fine or penalty, whether civil or criminal.
- Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

However, a fine or penalty does not include any of the following.

- Legal fees and related expenses to defend in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
- Court costs or stenographic and printing charges.

- Compensatory damages paid to a government.

8.1.3 Cost Incurred while Earning Tax Exempted Income and Final Tax Deduction Amounts [§21(1)(c)]

To be an excluded income that should be either exempted or final withholding. Thus, expenses of excluded income are not deducted from taxable income. It is a matching concept of tax accounting.

☐ **Cost Incurred while Earning Tax Exempted Income**

Costs incurred while receiving or earning tax exempt amounts are not deductible because the income to which they are related is not taxable. If only a part of the taxpayer's income is taxable then only the expenses related to the taxable part of the income are deductible.

EXAMPLE 8-15 If a person received agriculture income that is lawfully exempted from income tax, he must not deduct any expenses paid to obtain this exempted income. But, if a person received business income that is not exempted from income tax, he can deduct all the relevant expenses paid to receive this taxable income.

EXAMPLE 8-16 An entity purchased debenture of a Limited Company (hotel) and share of a Co-operative Society Limited (agro-based co-operatives registered under Co-operatives Act 2048). The entity received dividend Rs. 10,600 and interest Rs. 9,400 for the year. If the entity spent Rs. 1,000 to receive these incomes, the expense has to be separated proportionately as given below:

Total of spent amount to collect both income		1,000
Divide by	Total collected amount	20,000
Multiply by	Portion of the taxable income	9,400
Deductible amount		360

Thus, deductible amount of interest collection is to be Rs. 360.

☐ **Cost Incurred while Earning Final Withholding Payments**

Cost incurred to receive or earn final withholding payments is not deductible because the income to which they are related is not taxable.

EXAMPLE 8-17 In an income year, a person received dividends from resident company Rs. 3,000. The resident company withheld dividend tax Rs. 150 (Rs. 3,000×5 percent) on gross amount of dividends to be paid. At the end of the year the resident person will not be subject to income tax on Rs. 3,000 of dividends previously taxed at the source of payment.

EXAMPLE 8-18 An individual makes two types of investment income. In an income year, he received rent income letting a house to a resident person Rs. 50,000 and royalty income writing books Rs. 140,000. He incurred Rs. 1,000 and Rs. 1,700 respectively to collect those incomes. In this context, the rent income is final withholding payment. That's why he should not include rent income in his taxable income and he must not deduct the expenses of collection of house rent income.

8.1.4 Any Distribution of Profit by an Entity

Where an entity distributes its profit to its shareholders it must not reduce the entity's taxable income. Thus, no deductions are allowed for distributions of any profits by entities. The distribution of profits is considered by entity when it satisfies the following requirements.

- A distribution of an entity is treated as a distribution of profits or a repayment of capital only if it reduces the net value of the entity's assets and liabilities. [§53(3)]
- A distribution of an entity is treated as a distribution of profits to the extent that it is at the time of the distribution, the market value of the entity's assets exceeds the market value of the entity's liabilities plus capital contributions to the entity including by way of capitalization of profits; or if profits are capitalized. [§53(4)]

EXAMPLE 8-19 A Company made a distribution to its shareholders. This distribution reduced its shareholder's face value price from Rs. 100 to 75 per share. Thus, it is taken into account as repayment of capital and it does not deduct business income.

EXAMPLE 8-20 An entity made a distribution of profits to its shareholders. If this distribution does not reduce the liability of the company, it is considered as dividend. Hence, it must not reduce the taxable income of the company.

EXAMPLE 8-21 An entity capitalized its profit issuing 1:1 bonus share to its shareholders. It is also taken into account as a distribution of profits and this amount of capitalization must not reduce the taxable income of the business.

8.1.5 Other Expenses

Recognition of revenue and expenses is in accordance to commerical accounting of GAAP. According to matching principle, revenue should match the expense, if possible. If not so, the expenses must not reduce the taxable income.

EXAMPLE 8-22 A person introduced into a contract agreeing to receive its income in the following income year. However, it has to begin its work from this year. It costed a lot of amount during the year. According to matching principles, the person has to account the costs in the following year. Thus, if an expense which adverses to matching principles, that come to be non-deductible.

EXAMPLE 8-23 A School made an agreement with its teacher. According to the agreement a certain salary was fixed to the teacher and simultaneously there was another agreement by which an identical sum was to be returned by the teacher to the school as donation. In reality, the agreement agrees that there was no contract to pay and receive salary. Thus, a fictitious expense must not be deducted from taxable income.

☐ Costs of Capital Nature

Deductions from taxable income are denied for any type of expenses of a capital nature. The costs of capital nature also include the following:

- Expenses incurred in respect of natural resource prospecting, exploration, and development is denied for deduction from taxable income.
- Expenses incurred in the acquisition of fixed asset have to be capitalized including its value.
- Expenses incurred on the disposal of a liability are deductible only if income derived from the disposal of business assets or business liabilities.

☐ Foreign Income Taxes

In principle, foreign income tax must not be deducted because foreign tax offsets are provided in the form of foreign tax credits. Instead of claiming a foreign tax credit, the person may choose to claim a deduction for foreign income tax for which the tax credit is accessible. In this case, a deduction is not denied and the person may reduce his taxable income by the foreign income tax.

EXAMPLE 8-24 In an income year, a person had taxable income Rs. 200,000 in foreign country "X" and paid profit tax in that country Rs. 35,000 (200,000×17.50% tax rate, in equivalent Nepalese currency). The person included this profit in its income tax return in Nepal. Then, the taxable income for the person is Rs. 700,000. In this case, he should calculate his taxable income as shown below.

Taxable income (Including 200,000 earned in country "X")	Rs.700,000
Tax liability (Individual natural person)	Rs.175,000
Less: Foreign tax credit (country – "X")	Rs. 35,000
Tax payable for the year	Rs 140,000

It is an option for foreign tax credit. If the person claims foreign tax credit, it must not be deducted from his taxable income.

EXAMPLE 8-25 If a person does not claim foreign tax credit, the person may deduct its foreign tax as deductible expense. In such a case, the person will compute its tax liability as given below:

Taxable income (including 165,000 earned in country "X")	665,000
Tax liability (Individual natural person)	Rs. 166,250
Less: Foreign tax credit (paid in country "X")	Rs. – .
Tax payable for the year	Rs 166,250

It is second option for deduction of foreign tax as an expense. A person if did so, the foreign tax recognize as deductible expense.

8.1.6 Special Rules for Deductions Denied for Large Taxpayers [§21(2)]

In case of persons like individuals or entities with an annual turnover amounting rupees two million or more, in principle, deductions are not allowed for cash payment in excess rupees 50,000 at one time. Where cash payment is defined as a payment made other than through a bank or financial institution by way of letter of credit, check, draft, money order, money transfer (hundi) or any other form.

However, it is expressly allowable deduction from income from business or investment if cash payment made to the following persons and payments.

(a) It is made to the Government of Nepal, a constitutional body, a corporation owned by the Government of Nepal, or a bank or financial institution.

(b) It is made to a farmer or a producer of primary agriculture products, also if the product is primarily processed by the farmer himself.

(c) It is a retirement contribution or a retirement payment if paid to a beneficiary.

(d) It is made in an area where no banking facilities are available within a radius of 10 kilometer.

(e) It is and necessarily must be made in cash or on a day when banking services are closed.
(f) It is made into a bank account of the recipient.

REVIEW QUESTIONS AND CASES

1. "Costs incurred while receiving or earning tax exempt and final withholding amounts is not deductible amount". Justify this statement.
2. How do you separate personal and domestic expenses from proprietorship business? Explain with examples.
3. List the items for special rules for deductions denied for large taxpayers.
4. "Foreign income tax must not be deducted because foreign tax offsets are provided in the form of foreign tax credits". Illustrate this statement with example.

Chapter 9

Calculation of Net Gains from Assets and Liabilities

9.1 NET GAINS FROM ASSETS AND LIABILITIES

A capital gain is capital profit that is realized from the sale of an asset that was previously purchased at a lower price. The sale of an asset if yielded a loss is called a capital loss. The most common capital gains are realized from the sale of stocks, bonds, and property. Capital gains are often exempt from income tax and sometimes these are taxed by different tax rate in which it may be important to distinguish capital gains or losses realized on the sale of fixed assets from trading profits or losses realized on the sale of trading stock. In many jurisdictions, including the United

States and the United Kingdom capital gains are subject to capital gain tax (CGT).

9.1.2 Net Gains from Disposal of Business Assets and Liabilities [§36(1)]

Income from business includes net gains from the disposal of business assets or liabilities of a person. The calculation of net gains from the disposal of business assets or liabilities of a person for an income year should be made by adding all gains from the disposal of business assets or liabilities of the business during the year after deducting total losses suffered from the disposal of business assets or liabilities of the business during the year, any unrelieved loss out of the net loss from any other business of the person during the year and any unrelieved loss out of the net loss in an income year or in the past income years from the business or any other business of the person.

Table 9.1: Calculation of net gains from disposal of business assets and liabilities

Incomings		**Amount**
Equals	Amount derived from disposal of business assets or liabilities	××
Outgoings		
Less:	(1) Cost of the assets or liabilities	(×)
	(2) Cost of the disposal of assets and liabilities	(×)
	(3) Other expenses, if any	(×)
Gain or loss from the disposal (if gain)		××
Less:	(1) Net loss from any other business of the person during the year	(×)
	(2) Net unrelieved loss from business during income year and past income years	(×)
Net gain from disposal of business assets and liabilities		×

EXAMPLE 9-1 A person disclosed the particulars of business assets and liabilities for an income year: (1) amount received from disposal of business assets Rs. 170,000 and the value of the disposed assets Rs. 130,000 (2) Unrelieved business loss of the business from previous year Rs. 15,000 (3) other for the year was Rs. 10,000. In this context, the person's net gain from disposal of assets and liabilities is calculated as given below:

Incomings		**Amount**
Equals	Amount derived from disposal of business asset	170,000
Outgoings		
Less:	(1) Cost of the assets	(130,000)
	(2) Other expenses	(10,000)
Gain from the disposal		30,000

Less	Net unrelieved loss of the business from previous year	(15,000)
Net gain from disposal of business assets		15,000

EXAMPLE 9-2 A person has owned two businesses: Space and Land. The person disclosed the particulars of business assets and liabilities for an income year- for 'Space': (1) amount received from disposal of business assets Rs. 290,000 and value of the disposed assets Rs. 190,000 (2) other expenses relating to assets Rs. 20,000 and (3) Unrelieved business loss of the business from previous year Rs. 25,000. Similarly, for 'Land': (1) Unrelieved loss of business from previous year Rs. 35,000. (2) Unrelieved loss for the year Rs. 15,000. In this situation, the net gain from disposal of assets and liabilities is calculated as given below:

Incomings			**Amount**
Equals	Amount derived from disposal of business assets		290,000
Outgoings			
Less:	(1) Cost of the assets or liabilities		(190,000)
	(2) Other expenses relating to assets		(20,000)
Gain from disposal of business assets			80,000
Less:	(1) Net loss from 'Land' during the year		(15,000)
	(2) Net unrelieved loss from previous year		(60,000)
	(a) Space	Rs. 25,000	
	(b) Land	Rs. 35,000	
Net gain from disposal of business assets			5,000

Thus, in short, net gains from assets and liabilities of a person is that amount of total gains which is obtained after deducting total losses including carry forwarded.

9.1.2 Net Gains from the Disposal of Non-Business Taxable Assets [§36(2)]

Net gains from the disposal of non-business taxable assets of an investment of a person for an income year should be computed by deducting the total of all losses suffered from the disposal of non-business taxable assets of the investment during the year; any unrelieved loss out of the net loss from any losses of business or investment of the person during the year; and any unrelieved loss out of net loss of any previous income years from the investments, any business or other investment of the person.

Table 9.2: Calculation of net gain from disposal of non-business taxable assets

Total of all gains		**Amount**
Equals	Total of all gains derived from disposal of non-business taxable assets of an investment during the years	××
Total of all losses		
Less:	(1) Total of all losses from disposal of non-business taxable assets of an investment during the year	(×)
Any unrelieved net loss		
	(2) Any unrelieved net loss out of any losses of business or investment for the year	(×)
Any unrelieved net loss		
	(3) Any unrelieved net loss out of the losses of investment, any business or other investment for the previous year	(×)
Net gain or loss from the disposal of non-business taxable assets		×

EXAMPLE 9-3 An individual gained Rs. 52,000 from disposal of non-business taxable assets. The individual had also unrelieved loss of business Rs. 37,000. In this condition, the person can deduct all unrelieved loss from the amount derived from disposal of non-business taxable assets.

9.2 DISPOSAL OF AN ASSET OR LIABILITY WITH RETENTION [§41]

In case, where a person disposes off an asset or a liability in any manners: (1) when a debt claim becomes bad debts, (2) when the use of assets changes, (3) when a person becomes non-resident, and (4) the ownership of an entity changes; that results also in the disposal of an asset and liability. In this context, the following principles are applied:

9.2.1 Disposal of assets [§41(a)]

In case of an asset with regard to disposal, the person has to be treated as having derived an amount equal to the market value of the assets at the time of disposal; and the net outgoings for the asset at the time of next disposal is to be treated as equal to the amounts as outgoing.

9.2.2 Disposal of Liabilities [§41(b)]

In case of liability, the person has to be considered to have incurred expenses for the disposal of an amount equal to the market value of the liability at the time of disposal; and the net incomings for the liability at the time of next disposal has to be treated as equal to the amount of outgoings.

9.3 DISPOSAL BY WAY OF INSTALLMENT SALE [§42]

Where a person disposes off an asset by way of installment sale or leasing the asset to another person under a finance lease is considered to have derived an amount equal to the market value of the asset at the time of disposal and the persons who acquires the assets has to be considered to have incurred costs of an amount equal to that mentioned amount of market value. But, the provision under transfers between associates and other non-market transfers are not applied for this case.

EXAMPLE 9-4 A person purchased a vehicle under finance lease at Rs. 500,000. At that time the market value of the vehicle was Rs. 400,000. If it disposed in the incoming of Rs. 400,000, it incurs loss of Rs. 100,000.

9.4 TRANSFER OF ASSET TO SPOUSE OR FORMER SPOUSE [§43]

If a divorced or a person who has taken her/his share and is living separately disposes off an asset by way of transfer to a spouse or former spouse and an election is made by the spouse or former spouse in writing, then the person has to be considered to have derived in respect of the disposal, an amount equal to the net outgoings for the asset immediately before the disposal and the spouse or former spouse has to be considered as incurring in acquiring the asset by way of transfer for an equal amount of aforesaid outgoings.

EXAMPLE 9-5 A resident natural person purchased a piece of land in Rs 2,000,000. After two years, half portion of land transferred to his former spouse. The spouse sold this land to another person in Rs. 1,500,000. In this context, her outgoing and incoming has to be considered Rs. 1,000,000 and 1,500,000 respectively. Thus, her gain from disposal of assets is taken into account as Rs. 500,000.

9.5 TRANSFER OF ASSET ON DEATH [§44]

If on the death of an individual, an asset is disposed off by way of transfer of ownership of the asset to another person. The individual has to be considered to have derived, in respect of the disposal, an amount equal to the market value of the asset at the time of disposal. The person who acquires ownership of the asset by way of transfer is to be treated as incurring in the acquisition costs of an amount equal to that value.

EXAMPLE 9-6 A person acquired a piece of land after the death of his relative. At the transferred time the market value of the land was Rs. 800,000. In this context, the amount of Rs. 800,000 is to be

considered as received by the dead person and paid by the person to acquire land.

9.6 TRANSFER BETWEEN ASSOCIATES AND OTHER NON-MARKET TRANSFERS [§45]

Where a person disposes off an asset by transferring asset to spouse or former spouse and transfer asset on death to an associate to any other person for no returns, the person has to be treated as having derived in respect of the disposal whichever amount is greater between the market value of the assets or the net outgoings for the assets immediately before the disposal. The person who acquires ownership of the asset has to be treated as having incurred in the acquisition costs of an amount to that treated derived amounts.

REVIEW QUESTIONS AND CASES

1. What is gain? How is it differs from profit? Explain.

2. What are the differences between business assets and non-business taxable assets?

3. A business person presented the following statement for an income year. You are required to calculate net gain from disposal of business assets or liabilities.

1. Amount derived from disposal of business assets Rs. 35,000,000.
2. Cost of the assets Rs. 15,000,000.
3. Cost of the disposal of assets Rs. 105,000.
4. Net loss from disposal of business liabilities during the previous year Rs. 250,000.
5. Net loss from other business of the person during the year Rs. 150,000.
6. Net unrelieved loss from business from previous income years Rs. 1,250,000.

4. An individual presented his transaction about non-business taxable assets as:

1. Sale of 'A' house and land during the year Rs. 37,800,000 which was purchased on Rs. 18,000,000 in one year ago.
2. Sale of 'B' house and land during the year Rs. 7,000,000 which was received as inheritance property after his father death at that time the value of house and land was Rs. 1,000,000.
3. Costs of R&I of both house were Rs. 130,000 and Rs. 150,000 respectively.

You are required to calculate net gain from disposal of non-business taxable assets.

Chapter 10
Business Income

10.1 CONCEPT OF BUSINESS

Business is a typical economic activity with primary objective of income or profit. The economic activity must be continuous and regular with the production of goods or simply purchase of goods to resell at a profit. The economic activity always involves an element of risk of loss or threat or uncertainty. Thus, in short, business is a continuous and regular activity that has income or profit as its primary purpose.

Business contains two concepts: old concept of business and changing concept of business. The first concept involves the objective of profit maximization while the later bases on human

welfare, consumer satisfaction and economic development as a whole. Peter Drucker points out that basic purpose of business is to create customers. Business is also directly related with the market change and economic activity.

The term business also refers to an enterprise, commercial entity, or firm in either private or public sector, concerned with providing products or services to satisfy customer requirements. These are distinguished from one another according to the types of enterprise operations, trades, or professions. Classification is the act of organizing a list of types of operations, trades, and or professions or enterprises. Business is an enterprise but not all enterprises are businesses. For example, a government enterprise would not be classified as business although it could be an economic enterprise. Any operation that burdens taxpayers is not considered to be a business enterprise and may only indirectly contribute to economic development. A location may have a government operation, such as military base that employs civilians from the community or that supports local businesses as suppliers and contractors. In that case, the government operation may certainly be viewed as a contributor to economic development.

Thus, business is a lawful activity, conducted primarily for the purchase, sale, lease, manufacture, processing, marketing of products, commodities, or for the sale of services to public.

10.2 CHARACTERISTICS OF BUSINESS

The activities termed 'business' contain the following characteristics:

☐ Profits as Reward for Service Rendered

In 1999, Shukla writes that business is an activity by which men make their living or earn profit. Profit is an essential characteristic of business and it motivates to give continuity to the business. The hope of making a good profit also attracts men of ability to business. In fact, profit is, in a sense a reward for an individual's ability or efficiency of the enterpriser and also for the service that he renders to the community.

☐ Risk and Uncertainty

Every economic activity involving profits also takes the part of risk. Business may never run without risk and uncertainty. In business, if any subject exists certain is the uncertain for the

future. Thus, the business always involves certain amount of risk and uncertainty of return to entrepreneur in future.

☐ Sale or Transfer of Title

Sale or transfer of title of asset is the primary function of business. It may be in terms of service. Again, it may be in terms of tangible items such as sale of goods to customer. Thus, in business sale, lease, acquisition, manufacturing, processing or similar activities are administered as one form to another form or one hand to another hand by transferring the title. It is another characteristic of business.

☐ Continuous and Regular

Business adopts continuous and regular economic activities. If anyone does economic activity only once, it is not called business. For example, a person if sold his residential house for his lifetime is not a business. Thus, business holds a character of continuous and regular economic activities.

☐ Business Includes Trade, Commerce and Manufacture

Business may be in different nature: trade, commerce or manufacture. According to Bourvier's Law Dictionary, in its most extensive signification "trade" includes all sorts of dealings by way of sale or exchange. In a more limited sense, it signifies the dealings in a particular business, as the India trade; by trade is also understood the business of a particular mechanic, hence boys are said to be put apprentices to learn a trade, as the trade of a carpenter, shoemaker, and the like.

Commerce is an exchange of commodities for commodities; considered in a legal point of view, it consists in the various agreements which have for their object to facilitate the exchange of the products of the earth or industry of man, with intent to realize a profit.

Similarly, manufacture includes two classes of products; first, all machinery which are used and not the object of sale; and secondly, substances (for example: medicines) manufactured by chemical processes which cannot be preserved in permanent form. In the first class, the machine and in second, the substance produced is the subject of patent.

☐ Business cannot be Carried on with Oneself

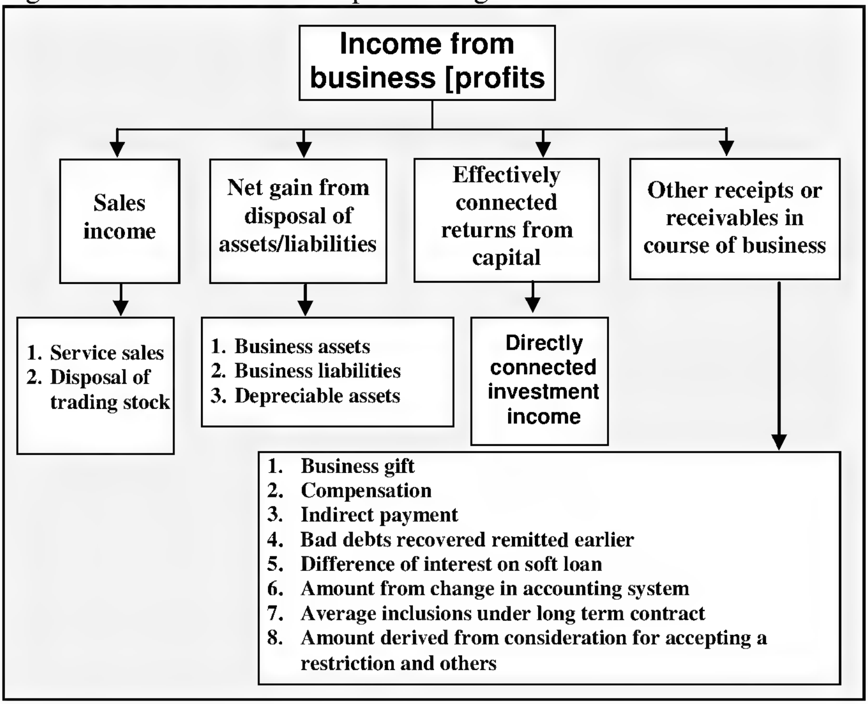
The business needs at least two parties to conduct it and to make a profit. The transaction requires contract and its validation from

others. A person cannot make any profit from the transaction of oneself. Thus, the involvement of parties is an essential character of business.

10.3 PROFIT AND GAINS FROM BUSINESS

A person's income derived from business in an income year is the person's profit and gains from operating the business in that year. In calculating a person's profits and gains from operating a business for an income year, the Act has prescribed specially four sub-titles for inclusions. Those are: income from sales, net gain from disposal of assets or liabilities, effectively connected returns from capital and other receipts or receivables in course of ordinary business.

Figure 10.1: Classification of profit and gains



10.3.1 Sales Income

ITA 2002 divides sales income of any business into service fee [§7(2a)] and disposal of trading stock [(§7(2b)]. It denotes that sales income can be divided into two sub-heads: sales of service and disposal of goods. Thus, the sales of service and disposal of goods are to be accounted

under service fee and amount derived from disposal of trading stock respectively.

☐ Service Fee [§7(2)]

Service fee includes merely income from service other than disposal of trading stock. Therefore, any amount in the form of service fee or charge or any other similar name received by any person for any service rendered in excise of business has to be included in profit and gains from business. Under this head, the following incomes from service should account for service fees. In simple, service fee refers sales income of intangible service.

> **EXAMPLE 10-1** If a business derives income providing service (except selling of goods), it is called service fee. Thus, entrance fee of movie business, commission on premises, equipment, or share brokerage, sales income on trekking, rafting, or traveling, commission on agency service, income on consultation, visiting, checking, translating, engineering, layering, auditing, manpower supplying etc. are examples of the service fees.

☐ Amount Derived from Disposal of Trading Stock [§7(2) (b)]

It is a sale of tangible item. It includes sales of all goods, which have weight, measurement, size and shape. All amounts derived from disposal of trading stock are to be included in this sub-head for person's profits and gains from business.

> **EXAMPLE 10-2** A person markets two products: counseling service for volt guard of the second company and sale of stabilizer of its own. If the person derived commission income from the second company in lieu of counseling of volt guard Rs. 1,250,000 and sales income of own stabilizer Rs. 2,500,000, the person has to account to these incomes Rs. 1,250,000 and Rs. 2,500,000 in service fee and amount derived from disposal of trading stock respectively.

10.3.2 Net Gains from Disposal of Business Assets or Liabilities

There are five assets exist in total. Business and depreciable assets are two out of those five assets. If these disposed in an income year the appropriate accounting adjustments are to be made for tax purposes.

☐ Net Gains from Disposal of a Person's Business Assets or Liabilities [§7(2)(c)]

Business asset is that, which is used in business but that is neither trading stock nor depreciable asset. Similarly, business liabilities are outside liabilities of business. So, net gain from disposal of business assets and

liabilities are also to include in business income. The net gain of business asset of a person for a year has to calculate by adding all gains from disposal of business assets or liabilities of business and subtracting the following loss of the business, if any [§36(1)].

Table 10.1: Calculation of net gain from disposal of business assets and liabilities

Equals	The gain from disposal of business assets/liabilities	xxx
Less:	(1) Total loss arising from disposal of business assets/liabilities of business during the year	(x)
	(2) Any unrelieved loss from other business of a person during the year	(x)
	(3) Any unrelieved loss from previous year(s) from the business or any other businesses of a person	(x)

EXAMPLE 10-3 A Company sold business asset item "A" in a month and received net gain Rs. 15,000. Similarly, in next month it sold business asset item "B" getting loss Rs. 14,000. In this position, the company has to include net gain from disposal of business assets only Rs. 1,000.

EXAMPLE 10-4 A person operates three businesses: "Sun", "Moon" and "Star". In a year, all three business disposed business assets/liabilities. As disposal: "Sun" gained Rs. 10,000; "Moon" resulted loss Rs. 5,000 and "Star" no gain and loss. Again, it had unrelieved loss of the previous year of Rs. 4,000. In this circumstance, the net gain from disposal of business assets/liabilities is to observe only Rs. 1,000.

☐ Amounts Treated as Derived from Disposal of a Person's Depreciable Assets of Business [§7(2)(d)]

In case of disposal of depreciable assets if a person disposes all assets of the pool before the end of an income year the pool is treated as dissolved. In this event, if disposal amount exceeds amount of depreciable base, the excess amount stands for amount derived from disposal of a person's depreciable assets of the business. Similarly, if disposal amount is inadequate to the depreciable base it is called loss from disposal and this loss accounts as expense.

Table 10.2: Amounts derived from disposal of depreciable assets of the business for an income year

Amounts treated as derived from disposal of a person's depreciable assets of the business		**Amounts**
Equals	A person's income either derived or to be derived from disposal of assets during the year	××
Less:	(1) The written down value of pool during the year	(×)
	(2) Outgoings added to depreciable base of the pool during the year	(×)
	(3) Outgoings to be added to depreciable base of the pool during following income year	(×)
Amounts treated as derived from disposal of a person's depreciable assets of the business		×

EXAMPLE 10-5 A person disposed its depreciable assets of pool "B" for Rs. 70,000. Depreciable base of that pool was only Rs. 50,000. In this context, amounts treated as derived from disposal of a person's depreciable assets of the business is Rs. 20,000.

EXAMPLE 10-6 A person disposed a portion of depreciable assets of pool "A" for Rs. 25,000,000. But, cost of the pool with depreciable base was Rs. 22,000,000. In this pool, if outgoings added to the depreciable base of the pool during the year is Rs. 150,000 and outgoings to be added to depreciable base of the pool during the following income year is Rs. 50,000, amount treated as derived from the disposal of a person's depreciable assets of business is only Rs. 100,000.

10.3.3 Effectively Connected Returns from Capital

Effectively connected returns from capital means in a way that produces a desired result joined or linked firmly together to yield something as a profit on an investment material wealth in the form of money or property capital or money that can be used to produce further wealth. Returns from capitals that are effectively connected with business, if received, are accounted in tax by 'amounts derived from investments that are effectively connected with the business (§7(2)(g)'. The investment income directly connected with business includes interest, rent etc.

EXAMPLE 10-7 An entity has a parted building to operate factory and let out to others. In this case, income derived from let out is investment income and it has to account as business income for

reason that the income is effectively connected with a business-by-business property.

EXAMPLE 10-8 A company deposited some amount as guarantee in a bank to operate its business and received interest from deposit. In this case, an outstanding point is that interest concerns with investment income. However, the interest has to be included under business income for the reason that amount derived from investment is effectively connected with business.

10.3.4 Other Receipts or Receivables in Courses of Business

The other receipts or receivables in course of business income are ordinary income, which generally occurs by the reason of accounting method, policies, principles, situation etc. This topic includes gift, accepting a condition, accounting method, devaluation of currency and so on.

☐ **Gifts Received by the Person in Respect to the Business [§7(2) (e)]**

If any person received any gift, whether convertible into cash or not out of his business in any income year, amount to be equivalent to the market value of such gift should be included in profits or gains from operation of business.

EXAMPLE 10-9 A Manufacturing entity gifted 10 items of its product including Rs. 10,000 to a wholesaler in respect to best seller for the year. If prevailing market value of the product is Rs. 1,600/item, the wholesaler has to include Rs 26,000 (Rs. 16,000 + Rs. 10,000) as business income received as a gift.

☐ **Amount Derived as Consideration for Accepting a Restriction on Capacity to Conduct the Business [§7(2)(f)]**

The term accepts is usually used in contract. "A contract is any legally enforceable promise or set of promises made by one party to another" (Anonymous, 2002). Therefore, accepting is recognizing something to do or not to do. Therefore, any amount derived from accepting any restriction to conduct the business has to be included in the person's income.

EXAMPLE 10-10 A person markets its two products—Brush and toothpaste—in two markets: Pokhara and Butwal. In an income year, the person accepted a proposal of second business organization not to market in Pokhara and derived Rs. 20,000 as a consideration of the acceptance. In this context, the person has to include Rs. 20,000 for amounts derived as consideration for accepting a restriction on capacity to conduct the business.

☐ **Amounts to be included by Reason of Change in Accounting System [§22(6)]**

A change in accounting method occurs when an accounting principle is used that is different from the principle used previously for reporting purposes. The Term "accounting principle" includes not only accounting principles and practices, but also the methods of applying them. Suppose that a change in inventory valuation from LIFO to FIFO is a change in method. But, the correction of an error in previously issued financial statements – computational errors, oversights, misapplication of an accounting principle – is not an accounting change or change in method. The entities other than companies and including sole proprietorship business are free to choose accounting system. A change in an accounting system directly affects its amounts of inclusions. A person can change his accounting system after receiving permission from the IRD. At the time of change, the difference may arise and it has to include or adjust properly. If the change in accounting system results into difference in amount, it has to include under this topic.

Plank and Blensly (1989) mention that a change of accounting method includes:

1. A change from cash to the accrual method for gross income and expenses,
2. A change in depreciation method,
3. A change in the basis for inventory valuation method,
4. Changes in the reporting entity; e.g., a change in the subsidiary – parent organization because the statements are considered to be those of a different entity and
5. Changes in the method for a material item; it means any item that involves the proper time for inclusion of an item in income or the taking of a deduction.

EXAMPLE 10-11 A sole proprietor had been adopting a cash basis method of accounting. He changed accounting method from cash to accrual during the year. This change of accounting method if relates adjustment and they are related to inclusion, the proprietor should make inclusion during the year.

☐ **Excess Amount Received by Reason of Exchange Rate [§24(4)]**

The exchange rate of foreign currency fluctuates frequently. A person, if received excess amount due to the exchange rate, it has to be included as income from business for tax purposes under the given head.

☐ **Amounts to be Included by Reason of Timing [§24(3)]**

In course of calculation, incomes from business inexactness in quantifying amounts occur. This directly results from use of the accrual

method of tax accounting. The taxpayer has to make appropriate adjustments while receiving or making payment.

> **EXAMPLE 10-12** A Company had a foreign currency accounts in a bank. If the amount of account increases as compared to deposit due to fluctuation of exchange rate, the excess amount of this account has to be included in business income.

☐ Recovered Amount of Bad Debts Deducted Earlier [§25(1)]

Where the person later refunds the amounts or recovers the expenses as required that are to be included in business income during the year the amount is received or recovered if they are deducted in earlier income year. But the person must be followed accrual method of accounting.

> **EXAMPLE 10-13** A person recovered two bad debts Rs. 20,000 and Rs. 40,000. Between these two bad debts, the first was deducted but the later was not deducted as an expense in earlier income year. In this context, the person has to include only the first bad debt item in his business income.

☐ Amounts to be Included as per Contract of Completion Basis in Case of a Long-Term Contract [§25(1)]

The long-term contract involves duration of more than twelve month. Thus, income of long-term contract belongs to the contracted years on completion basis. If the income of contract is not treated on completion basis, the difference amount of completion must include in business income.

> **EXAMPLE 10-14** A person signed long-term contract of two-year duration. The amount of contract was Rs. 24,000. The completion of work for the first year was 60 percent but the person has accounted as an income of only Rs. 12,000. In this situation, the difference amount of Rs. 2,400 also has to be included in business income for the year.

☐ Difference of Actual Interest and Interest as per Market Rate in Case of Soft Loan [§27(1) (d)]

As to stated provision, if any person is benefited by loan and that is lower than interest to be paid as per standard interest rate, the amount of interest has to be included to the extent it is lower. Suppose that, if an employee took a loan from the employer and granted interest rate is lower than market rate, the amount by which the interests payable is lower than the interest at the market rate has to be included into the employee's income as an in kind payment.

EXAMPLE 10-15 A person took loan Rs. 500,000 from an entity at the rate of five percent. But, prevailing market rate for this type of loan was 10 percent. In this condition, the person has to include the difference of interest from market rate. For the result, it is calculated as:

Interest rate in the prevailing market	10%
Interest rate charged by the person	5%
Difference of rate from the prevailing market rate	5%
Thus, multiplier in percent	5%
Difference of actual interest and interest as per market rate	25,000

Thus, the person has to include Rs. 25,000 as difference of actual interest and interest as per market rate against the soft loan.

☐ Indirect Payments [§29]

When a person designated to receive payment indirectly benefits from the payment made by payee or a person associated with the payee, the IRD by notifying in writing, shall consider the benefited person or person who appoints such person as the person authorized to receive the payment.

☐ Amounts Derived as Compensation [§31]

Where a person or an associate of a person derives a compensation amount, including a payment under insurance that compensates expenses or loss compensates of the business, the amount of compensation has to be included in the business income.

EXAMPLE 10-16 A person has insured his trading stocks. In an income year, his trading stocks destroyed by flood, the insurance company valued and compensated Rs. 500,000. In this event, Rs. 500,000 is to be included in business income and the cost of trading stocks, which was effected by flood, has to be deducted from trading stocks.

☐ Other Amounts to be Included in Profit & Gains of the Business

The inclusions of business income are left with open end to include other subjects if exist thereon. Under this head, the following subjected income can also be included:

☐ Cessation Adjustment

Certain extra-adjustments are necessary in computing income tax of a business on its cessation as compared to ordinary year-to-year computations: reserves and provisions against possible future

expenditure can become taxable; and inventory may be valued at its precise final disposal price, unused depreciation may be deducted and other allowances granted.

10.4 AMOUNTS EXCLUDED FROM BUSINESS INCOME

Exempt and final withholding amounts are excluded in calculating profits and gains from business. Those are:

1. Tax exempted income [§10]
2. Taxation of dividend [§54]
3. Controlled foreign entities [§69]
4. Final withholding payment [§92]
5. Amounts so as to include in calculating person's income from any employment and investment.

For details please refer to chapters:

4. Exempt Amounts and other Concessions;
5. Special Provisions;
6. Withholding; and
8. Deductions that are Not Allowed.

10.5 DEDUCTION FROM BUSINESS INCOME

Business expenses are the costs of carrying on a trade or business and they are usually deductible if the business is operated to make a profit. The following costs and expenses are deductible while computing person's income from business.

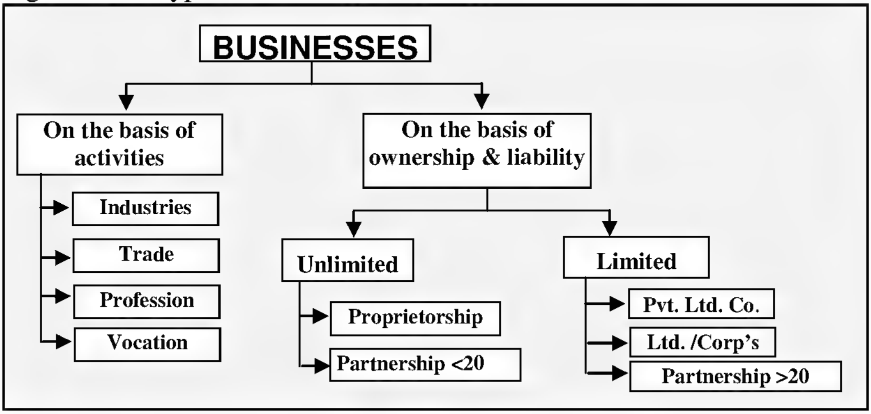
1. General deduction [§13]
2. Interest [§14]
3. Cost of trading stock [§15]
4. R&I costs [§16]
5. PC costs [§17]
6. R&D costs [§18]
7. Depreciation allowance [§19]
8. Loss of business or other businesses during the year or previous years [§20]
9. Deductible reserve [§59(1)]

For details, please refer to chapters: Seven (Deductions from Business and Investment Income) and Twelve (Set Off, Carry Forward and Carry Back of Losses).

10.5 TYPES AND FORMS OF BUSINESS

Business can be conducted in a number of different forms and those can be classified into different types. The major types and forms of businesses can be classified into the following categories.

Figure 10.2: Types and forms of business



10.5.1 Classification on the Basis of Business Activities

On the basis of activities, business organizations can be classified into four categories: industries, trade, profession and vocation.

❑ **Industry**

Industry is organized economic activity connected with the production, manufacture, or construction of a particular product or range of products that share a common method of generating profits, such as the 'rubber industry', the 'atomic power industry', the 'cattle industry' or the 'pesticide industry' etc. It is also used specifically to refer an area of economic production focused on manufacturing. It converts a shape or color of article into at least another shape or color. However, Industrial Enterprise Act 2049 classifies industries: manufacturing, energy, agro and forest based, mineral, tourism, service and construction industries in Nepal.

In general, the term manufacturing includes following activities:

1. The process engaged in a business of transforming raw or finished materials by hand or machinery through the application of human labor and skill into a product which has a new form, composition or character different from that in which it was acquired;

2. The printing and binding of books, newspapers, magazines or other periodicals;
3. The electroplating, galvanizing, anodizing, coloring, finishing, impregnating or heat treating of metals or plastics for use in the process of rolling, drawing or extruding of ferrous and non-ferrous metals;
4. Photo finishing and the processing and development of film, slides and photographs;
5. The operation of a sawmill or mill working on wood or wood products;
6. Cooking, baking, freezing of fruits, vegetables, mushrooms, fish, seafood, meats or grains and flours and placed in a sealed container for further wholesale or retail distribution; and
7. The brewing of beverages when such property is placed in a sealed container for further wholesale or retail distribution.

☐ Trade

The term trade implies buying and selling goods to make profit. It also involves an activity of exchange of goods and/or services. The exchanging activity of trade may be bilateral or multilateral. In its origin, the trade was barter and the exchange of goods and services and recognized equal value desirable to both parties. Modern traders generally negotiate through the use of a medium of exchange, i.e. money, and rarely through barter: as a result one can separate buying and earning from selling. The invention of money and subsequently of credit, paper money and non-physical money greatly simplified and promoted the development of trade. Trade may be internal trade within the territory of a State and external trade among the countries. Similarly, commerce is the exchange of something of value between two entities. That "something" may be goods, services, information, money or anything else the two entities consider to have value. Commerce is the central mechanism from which capitalism is derived. The process of transforming something into a commercial activity is called commercialization. Thus, commerce is the large scale activity of the trade among enities.

☐ Profession

Profession, in a more restrictive sense, refers specifically to fields that require extensive study and mastery of specialized knwoledge, such as law, medicine, engineering, nursing, accounting etc. Thus, the economic activities operated by lawyer, doctor, engineers, auditors are known as profession. It is quite different from occupation, which refers generally to the nature of a person's employment.

☐ Vocation

According to Black's Law Dictionary, "vocation is one's regular calling or business, occupation or profession. It may be professional or voluntary; however, it does not include employment".

Wikipedia conforms that vocation is an occupation, either professional or voluntary, that is seen more to those who carry it out than simply financial reward. Vocations can be seen as providing a psychological or spiritual need for the worker, and are often assumed to carry some form of altruistic intent. The term can also be used to describe any occupation for which a person is specifically gifted, and usually implies that the worker has a form of "calling" for the task. For these reasons, occupations which are seen as vocations often include those where a combination of skill and community help are implied, such as medical, care-giving, and veterinary occupations. Occupations where rewards are seen more in spiritual or other non-financial terms, such as religious occupations, are also seen as vocations. Borderline occupations, where community service and more personal reward are more evenly balanced, such as politics, may often be regarded as vocations.

Finally, vocation is a type of business which needs knowledge of expert but need not necessary to be an extensive study of mastery. For example, an engineer may be a furniture producer and seller where he does not use the knowledge of mastery is called vocation. If such furniture needs an expert knoledge of mastery is called profession.

10.5.2 Classification on the Basis of Ownership and Liabilities

On the basis of liabilities, business organizations can be classified into two categories: unlimited liability and limited liability.

☐ Unlimited Liability

Unlimited liability means unbounded by legal responsibility for obligation, especially costs or damages. Thus, in the unlimited liability organizations the investors, proprietor, or partners are unlimited up to their share or investment amounts.

1. **Sole proprietorship:** Sole proprietorship is the oldest, most common, and simplest form of business organization; owned and managed by one person. It can be organized very informally, is not subject to much state regulation, and is relatively simple to manage and control.

2. **Partnership:** Partnership is an association of two or more persons to carry on as co-owners a business for profit. In other

words, if two or more individuals do nothing more than verbally agree to conduct business as owners, a partnership is formed. The partnerships consist of relationships between two or more persons embodied in an agreement. Creation of the agreement establishes rights and duties between the partners and regulates their conduct as they transact business.

A source of partnership law has been codified in "Partnership Act, 1964 (2020)". According to the Act, no statutory filing (Memorandum of Association and the Articles of Association) needs to form and operate a partnership business. However, it needs a partnership deed that assists individuals in creating and defining the relationship between partners. It can also be a useful reference when the partnership agreement is silent on a particular topic.

☐ Limited Liabilities

Limited liability means bounded by legal responsibility for obligation, especially costs or damages. It is in the sense owners are liable for a company's debts only up to the value of their shareholdings. Categories of companies vary from country to country and go by different names. The main difference is between public and private companies. Public companies can sell their shares to the general public; private companies cannot sell shares to or raise money from the general public. In general, private companies tend to be smaller than public companies. However, some of Nepalese biggest companies are privately owned.

Thus, in the limited liability organization shareholders/investors are limited up to their share or investment amounts.

1. **Limited company:** Limited means limited with liability. So a limited liability business organization is a type of legal entity. It is similar to a corporation and a limited liability partnership. It has some advantages over sole proprietorship and unlimited partnership. The limited liability organizations again can be divided into four categorical firms: private limited company, partnership with more than 20 shareholders, limited company and corporations.

- **Private limited company**: Private limited company limits its number of shareholders. This type of business organization is possible to incorporate from sole shareholder to 50 shareholders. It does not float its shares for public and capital market in respect of equity capital. Moreover, it does not issue debenture for general public.

- **Partnership firm with more than 20 partners**: It is neither company nor corporation. But, according to ITA 2002, the partnership firm with more than 20 partners is also categorized into the limited liability.
- **Limited company**: Limited companies are not limited with number of shareholders. It may incorporate more than seven founder shareholders. The limited company can floats its share into capital markets. It can make equity shareholders to the common people. Shares of the limited companies are listed on stock exchange for liquide equity. In Nepal, all commercial banks (except National Commercial Bank), finance companies, insurance companies (except National Insurance Corporation) are examples of limited companies.

2. Corporation: Corporation is a legal entity. According to Oxford English Dictionary the term "corporation" is derived from Latin corpus (body), representing a "body of people", i.e., a group of people authorized to act as an individual. The term universitas also used to refer to a group of people but now refers specifically to a group of scholars. However, in colloquial usage "corporation" usually refers to a commercial entity set up in accordance with a governmental framework. In Nepal, there exists two types of corporations – fully owned and semi owned by the government. For instance: Nepal Airlines Corporation, Nepal Telecommunication Corporation (now, telecom company), Timber Corporation are examples of fully government owned organizations. Similarly, National Industrial Development Corporation, Salt Trading Corporation, National Insurance Corporation are examples of semi-government owned corporations. Most of these corporations are established under Panchayat regime by special chartered Acts.

10.6 INCOME TAX RETURN CALCULATION SHEET FOR BUSINESS INCOME

Calculation of profit and gain from business income for the income year 20..../20….

Inclusions			Amount
1	Service fee [§7(2)(a)]	×	
2	Amounts derived from disposal of trading stock (§7(2)(b)]	×	
3	Net gain from disposal of business assets and liabilities	×	
4	Amounts treated as derived from the depreciable assets	×	
5	Gift received by the person in respect to business [§7(2)(e)]	×	

6	Amounts derived as consideration for accepting a restriction on the capacity to conduct the business [§7(2)(f)]	×	
7	Amounts derived from investments that are effectively connected with the business [§7(2)(g)]	×	
8	Amounts to be included by reason of change in accounting system [§22(6)]	×	
9	Amounts to be included by reason of timing [§24(3)]	×	
10	Excess amount received by reason of exchange rate [24(4)]	×	
11	Recovered amount of bad debts deducted earlier [§25(1)]	×	
12	Amounts to be included as per contract of completion basis in case of long term contract [§25(1)]	×	
13	Difference of actual interest and interest as per market rate in case of soft loan [§25(1)(d)]	×	
14	Amounts paid to third person instead of actual payee [§29]	×	
15	Amounts derived as compensation [§31]	×	
16	Other amounts to be included in profit and gain	×	
17	**Total Inclusions (1 To 16)**	xx	xx

Deductible Expenses Incurred In That Year To Earn Income From Business			
18	General deduction [§13]	×	
19	Interest [§14]	×	
20	Cost of trading stock [§15]	×	
21	R&I costs [§16]	×	
22	PC costs (§17)	×	
23	R&D costs (§8)	×	
24	Depreciation allowance [§19]	×	
25	Deductible reserve [§59(1)]	×	
26	**Total of Deductions (18 To 25)**	xx	xx

Deductible Losses			
27	Losses transferred from other business in this year	×	
28	Carry forward of unrelieved losses –previous year	×	
29	**Total Losses (27+28)**	xx	xx

30	**Total Deductions** (26+29)	xx	xx

31	**Income or Loss From Business** (17- 30)	xx	
32	**Loss Transferred To Other Business Income** (If 31 > Zero)	(xx)	
33	**Income Or Loss From Business** (31+32)	xx	xx

Calculation of Assessable Income of an Individual Natural Person

Calculation of Assessable Income			
34	**Assessable Income From Investment**	×	
35	**Assessable Income From Business**	×	
36	**Assessable Income From Employment**	×	
37	**Assessable Income (Total Of Investment Business And Employment Assessable Income)**	xx	xx

Deductions From Assessable Income			
38	Contribution to retirement fund	×	
39	Donations to exempt organization (both)	×	
40	**Total Deduction From Assessable Income (38+39)**	xx	xx
41	**Taxable Income (37 - 40)**		xx

Reduction from Taxable Income				
Reduction:				
42	(1) Individual or couple/dependency limit	×	xx	
	(2) Pension income	×		
	(3) Disable person's facility	×		
43	Life insurance policy		×	
44	Remote area allowance		×	
45	Foreign allowance facility		×	
46	**Total Reductions (Total of 42 To 45)**		xx	xx

47	**Taxable Base (Tax Base / 41 - 46)**		xx

Calculation of Tax Liabilities			
48	Taxable income @ 10% (for capital gain)	×	
49	Taxable income @ prescribed	×	
50	Taxable income @ prescribed	×	
Calculation of Additional Tax			
51	1.5% of the taxable base of marginal bracket	×	
52	**Total of Liabilities (Total of 48 To 51)**	xx	xx

Tax Credit (Deduction of Medical Tax Credit)			
53	Medical tax credit		×

54	**Tax Liabilities (52 - 53)**		×

Calculation of Assessable Income of an Entity

Calculation of Assessable Income			
34	**Assessable Income From Business**	×	

35	**Assessable Income From Investment**	×	
36	**Assessable Income (Total of 34+35)**	××	××
Deductions From Assessable Income			
37	Donations to exempt organization (both)	×	×
38	**Taxable Income (36 -37) / Taxable Base**		××
Calculation of Tax Liabilities			
39	Taxable income @ prescribed tax rate	×	
Calculation of Additional Tax			
40	1.5% of the taxable income	×	
40	**Total of Liabilities**	××	××

10.7 SOLE PROPRIETORSHIP BUSINESS

Sole proprietorship is the oldest, most common, and simplest form of business organization; owned and managed by an individual. It can be organized very informally and do not require legal formalities. It is relatively simple to manage and control. In addition, sole proprietorship firm may be divided into two categories according to its operations: self employed and general proprietorship firm.

Prevalent characteristic of a sole proprietorship is that owner is inseparable from the business. Because they are same entity, the owner of a sole proprietorship has complete control over the business, its operations, and is financially and legally responsible for all debts and legal actions against the business. Another aspect of the same business organization aspect is that taxes on a sole proprietorship are determined at the individual income tax rate of the owner. In other words, a sole proprietorship does not pay taxes separately from the owner.

Sole proprietorship is a good business organization for an individual starting a business that will remain small, does not have great exposure to liability, and does not justify the expenses of incorporating and ongoing corporate formalities.

It is 'sole' proprietor in the sense that the owner has no partners. A business owned by a husband and wife jointly can still be considered a sole proprietorship; in others it would be considered a type of partnership. Thus, in proprietorship business any judgement filed against it, would be a problem for the owner. It does not pay corporate taxes.

EXAMPLE 10-17 A resident natural person registered a business under Firm Registration Act 2014. In this circumstance, the person recognizes a proprietor of that business firm and he qualifies the taxpayer of his firm.

EXAMPLE 10-18 Both husband and wife operated a business together. Moreover, they have contributed their share equally between them. In this event, however, the husband recognizes a proprietor of the firm. According to law, husband and wife never make partners in a firm.

Advantages and disadvantages of sole proprietorship business organization may be as listed below:

Advantages	Disadvantages
♦ Relatively little time and expense required for creation. ♦ Relatively few required formalities and regulatory requirements. ♦ No separate income tax filing for the company - income and losses are reported on the owner's tax return. ♦ It may be operated whether registered or not.	♦ Owner is personally responsible for the debts of the company, meaning the owner's personal assets may be used to satisfy business debts. ♦ It is difficult for a sole proprietorship to raise capital. Financial resources are generally limited to the owner's funds and any loans outsiders are willing to provide. ♦ This form of business will have unlimited liability, therefore, if the business is sued, it is the proprietor's problem.

10.7.1 Tax Provision to Sole Proprietorship Business

Taxable income from sole proprietorship business is additionally granted by: reduction as to family status[1] and reduction for life insurance premium. Moreover, tax rates for sole proprietorship business are classified into two brackets: 15 percent and 25 percent. The special industry operated by natural person under the status of sole proprietorship is granted additional facility.

Please refer to chapters: 14 (Taxable Income and Selection of Taxable Base) and **15** (Selection of Tax Rate and Calculation of Tax Liabilities) for details.

[1] Inserted by the Finance Act 2063 dated Srawan 1, 2063 (Provision includes additional facility of reduction for disable person. It provides 50 percent of the reduction of individual or couple/dependency limit).

CASES AND SOLUTIONS

1. The following is Income Statement of Mr. Dixit, a proprietor of Dixit manufacturing firm, established in underdeveloped area.

Particulars	Amount	Particulars	Amount
Opening stock	66,000	Sales	2,225,000
Purchase	960,000	Interest	25,200
Freight and insurance	40,000	Compensation	225,000
Manufacturing expenses	465,000	Net gain from disposal	
Sales return	6,000	of business liabilities	260,000
Factory insurance	12,000	Closing stock	122,800
Printing and stationery	12,000		
Local transportation	6,000		
R&I costs	40,000		
Entertainment expenses	50,000		
Donation to exempt entity	25,000		
R&D costs	600,000		
Depreciation allowance	165,000		
Staff salary	285,000		
Net profit	126,000		
	2,858,000		2,858,000

Additional information:

1. Opening stock and closing stocks were overvalued by 5 percent.
2. Amount of purchase used by proprietor was Rs. 25,000.
3. Interest income was collected from creditors at the rate of 5 percent in lieu of delay payment but fair market practice for this type collection was 10 percent.
4. Entertainment includes private expense of proprietor of Rs. 5,000.
5. Balance sheet of the firm discloses loss Rs. 50,000 that was unrelieved from two years.
6. The purchased transactions revealed that:
   (a) 10 percent of purchase was not familiar to the prevailing market rate due to goods purchased from relatives paying 50 percent more price considering family relation.
   (b) 90 percent of purchase regards for the prevailing market rate.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liability [10+3+3]

Solution:

Calculation of profit and gains and assessable income from business of Mr. Dixit for the income year 2063/064

Calculation of Profit and Gains From Business			
Inclusions		**Amounts**	**Amounts**
1	Amount derived from disposal of trading stock	2,219,000	
2	Amounts received from investments that are effectively connected with the business	25,200	
3	Net gain from disposal of business liabilities	260,000	
4	Compensation amounts	225,000	
5	Difference of actual interest and interest as per market rate in case of a soft loan	25,200	
Total inclusions		2,754,400	2,754,400
Deductible Expenses Incurred to Earn Income From Business			
1	General deductions [w/n 1]	360,000	
2	Costs of trading stock [w/n 2]	1,337,905	
3	R&I costs	40,000	
4	Depreciation allowance	165,000	
5	R&D costs [w/n 3]	425,747.5	
Total of deduction		2,328,652.5	2,328,652.5
Business income			425,747.5
Deductible Losses			
	Carry forward of unrelieved losses from previous year		50,000
Assessable income			375,747.25

Calculation of Taxable Income

Statement of Assessable Income		
1	Assessable income from business	375,747.25
2	Assessable income from investment	-
Assessable income		375,747.25
Deduction From Assessable Income		
	Donation to exempt organization	25,000
Taxable income		350,747.5

Calculation of Taxable Income [Taxable Base]

Taxable income		350,747.5
Reduction From Taxable Income		
1	Reduction of individual limit	100,000
2	Reduction - others	-
Total of reductions		100,000
Taxable income [taxable base]		250,747.5

Calculation of Tax Liabilities

Taxable Base		250,747.5
1	Taxable income/base not exceeding Rs. 75,000 @ 12% (80% of the 15%) and	9,000
2	Taxable income/base in excess of Rs 75,000 - Rs 9,000 plus 16 percent (80 percent of the 20 percent) of taxable income in excess of Rs 75,000. i.e., Rs. 175,747.50	28,119.60
Calculation of Additional Tax		
3	1.5% of the taxable base of the Rs. 175,747.50	2,636.21
Tax liabilities		39,755.81

Working note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Factory insurance	12,000	-	12,000
2	Printing and stationery	12,000	-	12,000
3	Local transportation	6,000	-	6,000
4	Entertainment expenses	50,000	5,000	45,000
5	Staff salary	285,000	-	285,000
	Total	365,000	5,000	360,000

2. Cost of trading stock

Cost of trading stock			**Amounts**
	Opening stock	66,000	62,857
	Less: amount of overvalued	3,143	
Add	Purchase	960,000	1,392,000
	Less: (1) Amount used by the proprietor	(25,000)	
	(2) Amount as to arms length concept (50% of Rs. 96,000)	(48,000)	
	Add: (1) Freight and insurance	40,000	
	(2) Manufacturing expenses	465,000	
Less	Closing stock	122,800	116,952
	Less: amount of overvalued	5,848	
Cost of trading stock			1,337,905

3. Calculation of R&D costs

1	Total of inclusion from business		2,754,400
DEDUCTIONS:			
1	General deduction	360,000	
2	Cost of trading stock	1,337,905	
2	R&I costs	40,000	
3	Depreciation allowance	165,000	1,902,905
Adjusted taxable income			851,495
	50% of the adjusted taxable income		425,747.5
	R&D costs incurred during the year		600,000
Thus, deductible R&D cost is Rs. 425,747.5			

Clarification:

1. Goods used by proprietor has to omit from cost of purchase.
2. As per law, purchase and sales are not permitted neither lower nor higher price from relatives. The transactions of business are to as to arms length concept.
3. Industries other than alcohol and derivatives of tobacco regard as special industries. The tax rate for those industries is granted at the rate of 20 percent. Moreover, if industries are situated in underdeveloped area, the tax is levied at the rate of 80 percent of the rate otherwise applicable.
4. R&I cost is to allow for deduction as written in income statement in absence of comparison.
5. Interest earned from credit sales represents business income.

2. The following is Receipt and Payment Account of Mr. Kafle, self-employed professional writer, a disable person for the previous year.

Receipt and Payment Statement

Receipts	Amount	Payments	Amount
To balance of cash	20,000	By computer purchase	80,000
To receipt from writing	600,000	By software purchase	50,000
To proof reading income	150,000	By vehicle purchase	200,000
To receipt from		By PC costs	400,000
program operating	350,000	By salary to assistants	350,000
To interest from fixed		By life insurance	15,000
deposit (net)	47,000	By donation to a club	40,000
To interest from		By newspaper	12,000
domestic lending	20,000	By office rent	40,000
To amount received in		By stationeries	35,000

respect of accepting a condition of not writing an article in publication	50,000	By R&I cost -computer	18,000
To income from natural resources	60,000	By car fuel expenses	23,000
		By interest collection charge	2,400
		By expenses of natural resources	8,600
		By donation to a club	40,000
		By balance of cash	23,000
	1,297,000		1,297,000

Account scanning information:

1. Fuel expense concerns that 80% for professional works and 5% to income from natural resources.
2. Depreciable base value of computer was Rs. 175,000 including absorbed addition made in the previous year.
3. Software was purchased for 5 years.
4. Insured amount of life insurance policy was Rs. 250,000.
5. Interest received from domestic lending represents loan of 5 percent interest but the prevailing market practice of interest, the rate was 10 percent.
6. Allowable depreciation allowance except software was Rs. 75,000 including Rs. 5,000 depreciation of investment income.
7. In accrual accounting basis, Mr. Kafle rights a compensation income for Rs. 40,000 and obliges its expense of Rs. 8,000.

Required:

(a) Assessable income from (business) profession

(b) Statement of taxable income

(c) Tax liabilities [3+1.5+1.5]

Solution:

Calculation of profit and gains and assessable income from business (Profession) of Mr. Kafle for the income year 2063/064

Calculation of Profit and Gains From Business				
Inclusions			**Amounts**	**Amounts**
1	Service fees:		1,100,000	
	(a) Receipt from writing	600,000		
	(b) Receipt from proof reading	150,000		
	(c) Receipt from program	350,000		
2	Amount received from accepting a condition about articles writing		50,000	
Total inclusions			1,150,000	1,150,000

Deductible Expenses Incurred to Earn Income From Business			
1	General deductions [w/n 1]	455,400	
2	R&I costs [w/n 2]	12,250	
3	Depreciation [Rs.70,000+(1/5×50,000)]	80,000	
4	PC costs [w/n 4]	301,175	
Total of deduction		848,825	848,825
Business income			301,175
Deductible Losses			-
Assessable income			301,175

Calculation of Profit And Gains From Investment			
Inclusions		**Amounts**	**Amounts**
1	Interest income:	70,000	
	(a) Interest income from FD 50,000		
	(b) Interest from domestic lending 20,000		
2	Difference of actual interest and interest as per market rate in case of soft loan	20,000	
3	Income from natural resources	60,000	
Total of inclusions		150,000	150,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM INVESTMENT			
1	General deductions [w/n 3]	12,150	
2	Depreciation	5,000	
Total deductions		17,150	17,150
Investment income			132,850
DEDUCTIBLE LOSSES			-
Assessable income			132,850

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business (prof.)	301,175
2	Assessable income from investment	132,850
Assessable income		434,025
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to a club [w/n 5]	36,760
Taxable income		397,265

CALCULATION OF TAXABLE INCOME [TAXABLE BASE]

Taxable income	397,265
REDUCTION FROM TAXABLE INCOME	
Reductions:	

1	(a) Individual limit	100,000	150,000
	(b) Disable person's facility	50,000	
2	Life insurance premium		10,000
Total of reductions			160,000
Taxable base			237,265

CALCULATION OF TAX LIABILITIES

TAXABLE BASE		237,265
1	Taxable base not exceeding Rs. 75,000 @ 15% and	11,250
2	Taxable base in excess of Rs 75,000 - Rs 11,250 plus 25 percent of taxable income in excess if Rs, 75,000 In taxable base of Rs. 162,265 @ 25%	40,566.25

CALCULATION OF ADDITIONAL TAX

3	1.5% of the taxable base of Rs. 162,265	2,433.98
Tax liabilities		54,250.23
Less:	Tax credit from interest income of fixed deposit	3,000
Amount of tax payable		51,250.23

Working Notes:

1. General deductions [business]

S.No.	Particulars	Total	Non-deductible	Deductible
1	Salary to assistants	350,000	-	350,000
2	Newspapers	12,000	-	12,000
3	Office rent	40,000	-	40,000
4	Stationeries	35,000	-	35,000
5	Car fuel expense	23,000	4,600	18,400
Total		460,000	4,600	455,400

2. R&I costs

Depreciable base		175,000
Deduction of R&I costs		
	Costs incurred during the year	18,000
	7% of the depreciable base	12,250
Thus, allowable R&I cost		12,250

3. General deductions [investment]

S. No.	Particulars	Total	Non-ded.	Deductible
1	Expenses of natural resources	8,600	-	8,600
2	Interest collection charges	2,400	-	2,400
3	Fuel expenses (5%×23,000)	1,150	-	1,150
Total		12,150	-	12,150

4. Calculation of PC costs

Total of inclusion from business			1,150,000
DEDUCTIONS:			
1	General deduction	455,400	
2	R&I costs	12,250	
3	Depreciations	80,000	547,650
Adjustable taxable income			602,350
	50% of the adjusted taxable income		301,175
	PC costs incurred during the year		400,000
Thus, allowable PC cost is to Rs. 301,175.			

5. Calculation of donation amount

Adjusted taxable income of a person from business		602,350
Assessable income from investment		132,850
Adjusted taxable income for donation purposes		735,200
	5% of the adjusted taxable income (5% of Rs. 735,200)	36,760
	Or gifted amount as donation during the year	40,000
	Or Rs. 100,000	100,000
Thus, deductible amount for donation is to Rs. 36,760.		

Clarification:

1. Interest income is return of money lent to another. The lent money relates to the proprietor not to his business. Therefore, interest income regards to investment income.
2. Sole proprietor business gets option of accounting methods. Thus, adopting cash method of accounting the accrual income and expenses are excluded to make inclusion and deduction.
3. Amortization cost of software consists for 5 years.
4. Life insurance premium for the natural person is deductible; whichever is lower in seven percent of insured amount or Rs. 10,000.
5. Disable natural person gets additional reduction of 50% of the reduction as to family status.

3. Given below is Receipts and Payments Account of Mr. Khaling, a medical practitioner for the previous year.

Particulars	Amounts	Particulars	Amounts
To opening balance b/d	250,000	By subordinates salaries	380,000
To consultation fees	300,000	By car purchase	450,000
To surgical fees	450,000	By cultivation expenses	20,000
To visiting fees	150,00	By telephone expenses	15,000
To Interest from		By miscellaneous exp.	90,000
domestic lending	50,000	By electricity bill	8,000

To agriculture income	22,250	By life insurance premium (own)	12,000
To income from natural resources	80,000	By life insurance premium (spouse)	14,000
To royalty from writing medical books after withholding	85,000	By collection cost of natural resources	2,000
To rent from letting out personal property	30,000	By donation to tax exempt entity	20,000
To interest from fixed deposit (net)	94,000	By R&D cost	300,000
		By balance c/d	200,250
	1,511,250		1,511,250

Additional information:

1. Rs. 16,200 was paid for R&I cost of car but in the above statement it is not included.
2. Miscellaneous expense relates to professional income.
3. Car was purchased on Chaitra of the previous year.
4. One third of telephone expense relates to his personal work.
5. The insured amounts of proprietor and his spouse were Rs. 200,000 and Rs. 150,000 respectively.
6. A patient was presented a gift to the medical practitioner, its prevailing market price was Rs. 12,000 but it is not accounted in the above statement.

Required:

(a) Assessable income from profession
(b) Assessable income from investment
(c) Tax liability [8+5+2]

Solution:

Calculation of profit and gains and assessable income from business (profession) of Mr. Khaling for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS				
INCLUSIONS			**Amounts**	**Amounts**
1	**Service fee:**		900,000	
	(a) Consultation fees	300,000		
	(b) Surgical fees	450,000		
	(c) Visiting fees	150,000		
2	Gift in relation to the profession		12,000	
Total inclusions			912,000	912,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS				

1	General deductions [w/n 1]	488,000	
2	R&I costs [w/n 2]	16,200	
3	Depreciation allowance [car depreciation]	60,000	
4	R&D costs [w/n 4]	173,900	
Total of deduction		738,100	738,100
Business income			173,900
DEDUCTIBLE LOSSES			-
Assessable income			173,900

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT			
INCLUSIONS		**Amounts**	**Amounts**
1	Interest income (Rs. 50,000 + Rs. 100,000)	150,000	
2	Income from natural resources	80,000	
3	Royalty from writing medical books	100,000	
4	Rent from property	30,000	
Total of inclusions		360,000	360,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM INVESTMENT			
	General deductions		2,000
Total of deduction			2,000
Investment income			358,000
DEDUCTIBLE LOSSES			-
Assessable income			358,000

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business	173,900
2	Assessable income from investment	358,000
Assessable income		531,900
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to tax exempt entity	20,000
Taxable income		511,900

CALCULATION OF TAXABLE INCOME [TAXABLE BASE]

Taxable income		511,900
REDUCTIONS FROM TAXABLE INCOME		
Reductions:		
1	Couple limit	125,000
2	Life insurance premium	10,000
Total of reductions		135,000
Taxable base		376,900

CALCULATION OF TAX LIABILITIES

TAXABLE BASE		376,900
1	Taxable base not exceeding Rs. 75,000 @ 15% and	11,250
2	Taxable base in excess of Rs 75,000 - Rs 11,250 plus 25 percent of taxable base in excess of Rs 75,000. i.e., Rs. 301,900	75,475

CALCULATION OF ADDITIONAL TAX

3	1.5% of the taxable base of the Rs. 301,900	4,528.5
TAX LIABILITIES		91,253.5

Working Notes:

1. Calculation of general deductions:

1	Salaries to subordinates	380,000	
2	Telephone expenses (2/3 of Rs. 15,000)	10,000	
3	Miscellaneous expenses	90,000	
4	Electricity bill	8,000	
Total of general deductions		488,000	488,000

2. Calculation of depreciation allowance

	Depreciable base of car [2/3×450,000]	300,000
	20% of depreciable base	60,000
Deductible depreciation		60,000

3. Calculation of R&D costs

Total of inclusions			912,000
DEDUCTIONS:			
1	General deductions [w/n 1]	488,000	
2	R&I costs [w/n 2]	16,200	
3	Depreciation allowances [car]	60,000	564,200
Adjusted taxable income for R&D purpose			347,800
	50% of adjusted taxable income		173,900
	Incurred cost during the year		300,000
Thus, deductible amount of R&D cost is to Rs. 173,900.			

4. Calculation of donation amount

1	Adjusted taxable income from business	347,800
2	Assessable income from investment	358,000
Adjusted taxable income for donation purpose		705,800
	5% of adjusted taxable income	35,290
	Donated amount during the year	20,000
Thus, donation given during the year is to deductible amount.		

Clarification:

R&I cost of the car was already paid but it was not accounted in the statement. Thus, it must be deducted from income.

4. The following is the Income Statement of Mr. Deuja, a Trader for relevant income year:

Particulars	Amounts	Particulars	Amounts
Opening balance	300,000	Revenues	3705,000
Purchase	2,525,000	Closing stock	350,000
Freight and insurance	35,000		
Gross profit	1,195,000		
	4,055,000		4,055,000
Salaries	530,000	Gross profit	1,195,000
Audit fees	15,000	Net gain from disposal	
Interest expenses	150,000	of depreciable assets	
R&I cost - office		of the business	35,000
equipment	90,000	Net gain from disposal	
Donation	40,000	of non-business	
PC cost	220,000	chargeable assets	
Reserve for bad debts	10,000	(disposed value was	
Depreciation allowance	50,000	Rs. 10,600,000)	450,000
Provision for taxation	118,000	Interest income	75,000
Life insurance premium	30,000		
Printing and stationery	42,000		
R&D cost	197,500		
Net profit	262,500		
	1,755,000		1,755,000

Additional information:

1. Freight and insurance includes personal goods imported charge of Rs. 5,000.
2. Interest income consists:
   (a) Bank deposit Rs. 25,000 and
   (b) Soft loan to staff Rs. 50,000. (Soft loan for the staff was at the rate of five percent but prevailing market rate for such type of loan was 10 percent).
3. Opening balance of office equipment was Rs. 200,000 and on Falgun 1, of the previous year addition was made of Rs. 300,000.
4. Life insurance premium constitutes his spouse and adopted son Rs. 10,000 each. The premium of the spouse was paid by pin money.
5. Donation was paid to National Club. In the previous year that was not exempt entity however; that is exempt entity for the assessment year.

6. Unrelieved business loss from two years prior to current assessment year is Rs. 20,000.
7. 50 percent interest was paid to domestic moneylender and it was paid by cheque Rs. 15,000 and rest amount by cash at the end of Ashadh of the previous year.
8. PC cost includes contribution to retirement fund of staff contributed by the firm of Rs. 20,000.

Required:

(a) Assessable income from business

(b) Assessable income

(c) Tax liabilities [10+2+3]

Solution:

Calculation of profit and gains and assessable income from business of Mr. Deuja for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		**Amount**	**Amount**
1	Income from disposal of trading stock	3,705,000	
2	Net gain from disposal of depreciable assets of business	35,000	
Total of inclusions		3,740,000	3,740,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions (§13)	607,000	
2	Interest (§14)	90,000	
3	Cost of trading stock (§15)	2,505,000	
4	Cost of R&I (§16)	28,000	
5	Depreciation allowance (§19)	100,000	
6	Costs of PC (§17)	200,000	
7	Costs of R&D (s/18)	197,500	
Total of deductions		3,727,500	3,727,500
Business income			12,500
DEDUCTIBLE LOSSES			
	Less: Unrelieved loss from previous year		-
Assessable income			12,500

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT			
INCLUSIONS		Amount	Amount
1	Interest	75,000	
2	Difference of actual interest and interest as per market rate in case of soft loan	50,000	
3	Net gain from disposal of non-business		

	chargeable assets 450,000 Less: unrelieved loss of business from previous year (20,000)	430,000	
Total inclusions		555,000	555,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM INVESTMENT			-
	Investment income		555,000
Assessable income			555,000

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business	12,500
2	Assessable income from investment	555,000
Assessable income		567,500
DEDUCTION FROM ASSESSABLE INCOME		-
Taxable income		567,500

CALCULATION OF TAXABLE BASE

REDUCTION FROM TAXABLE INCOME		
Reductions:		
1	Couple limit	125,000
2	Life insurance premium	10,000
Total of reductions		135,000
Taxable base		432,500

CALCULATION OF TAX LIABILITIES

	Taxable income/base Rs. 430,000@ 10%	43,000
	Taxable income/base Rs. 2,500 @ 15%	375
Tax liability		43,375

Working Note:

1. General deductions

	General deductibles heads	Amount
1	Salaries	530,000
2	Audit fees	15,000
3	Printing and stationery	42,000
4	Contribution on retirement fund	20,000
Total of general deductions		607,000

2. Interest:

Real interest expense is deductible if interest fulfills basic requirements as:

(a) If fund is used to acquire the income
(b) Used by the person or/and
(c) Used during the year

However, a person whose annual turnover for an income year exceeds Rs, 2,000,000 is not allowed deduction for an installment cash payment in excess of Rs. 50,000 incurred other than in the following conditions:

(a) Payment made to a corporate body or the Government of Nepal
(b) Payment made to a farmer or primary agriculture producer
(c) Retirement contribution
(d) Payment made in an area where banking service is not available
(e) Payment made in banking service closed day
(f) Payment made to a bank account

Total interest expenses		150,000
1	Interest paid to bank (50% of Rs 150,000)	75,000
2	Interest paid to domestic money lender (50% of the Rs. 150,000)	75,000
Total		150,000
Less:	Non-deductible interest in cash payment	(60,000)
Deductible interest amount		90,000

3. Cost of trading stock

Opening stock			300,000
Add:	Purchase	2,525,000	2,555,000
	Add: freight, insurance and duty	35,000	
	Less: personal goods import charge	(5,000)	
Less:	Closing stock		(350,00)
Cost of trading stock			2,505,000

4. R&I cost: Not more than seven percent of depreciable base.

Opening balance of pool	200,000
Add: Absorbed additions: (2/3 ×300,000)	200,000
Less: Disposal during the year	-
Depreciable base	400,000
Thus, Rs. 28,000 of R&I cost is to deduct from inclusion and excess amount of R&I cost has to be capitalized in assets pool.	28,000
Calculation of depreciation (25% of depreciable base)	100,000

5. R&D and PC costs

R&D and PC costs are deductible not more than 50 percent of the adjusted taxable income.

6. Meaning of adjusted taxable income

Adjusted taxable income means an amount of taxable income of a person for an income year as calculated by ignoring reductions interest paid to tax exempt controlled entity, donation amounts, PC cost, and R&D cost.

Profits and gains			**3,740,000**
1	General deductions (§13)	607,000	
2	Interest (§14)	90,000	
3	Cost of trading stock (§15)	2,505,000	
4	R&I costs (§16)	28,000	
5	Depreciation allowance (§19)	100,000	3,330,000
Adjusted taxable income			410,000
	50 percent of the adjusted taxable income		205,000
	Debited PC costs (Rs. 220,000-20,000)		200,000
	Debited R&D costs		197,500
Therefore, real outgoings are deductible costs.			

7. Donations

Donation is calculated as not more than 5 percent of the adjusted taxable income or Rs. 100,000.

Adjusted taxable income [Rs. 410,000+555,000)		965,000
	Less: Unrelieved loss	-
	5% of the adjusted taxable income (ATI)	48,250
Donated amount is Rs. 40,000 but donation was paid to non-tax exempt entity in the previous year. Thus, all the amounts of donation become non-deductible from assessable income.		

8. Any provisions from business income other than provision of financial institution prescribed by NRB are non-deductible amounts.

5. Given below is Income Statement of a Timber Merchant, Mr. Dhamala for relevant income year.

Particulars	Amounts	Particulars	Amounts
Opening stock	250,000	Sales	4,000,000
Purchase	2500,000	Closing stock	350,000
Wages	800,000	Compensation income	70,000
Office staff salary	200,000	Interest income	150,000
Audit fees	15,000	Dividend income	6,000
R&I costs	20,000	Income from house	

General charges	15,000	rent owned by Dhamala	25,000
Commission (raising loan)	10,000	Income from natural	
PC costs	125,000	resources owned by	
Interest	50,000	the proprietor	50,000
Bad debts reserve	5,000	Assessable income	
Bad debts	20,000	from business run by	
Interest on capital	15,000	his wife	325,600
Contribution to staff R/F	25,000		
Provision for income tax	50,500		
Depreciation	25,000		
Net profit	850,500		
	4,976,000		4,976,000

In an investigation into the above income statement the following additional information are observed.

1. Compensation income was received from insurance company for loss of timber by flood. But, the stock of lost timber is not deducted from closing stock. The amount of compensation is 85 percent of actual loss of timber.
2. Fifty percent interest income was received from delay payment made by debtors and rest of amount of interest income belongs to investment.
3. Mrs. Dhamala donated Rs. 15,000 to an employee association (tax-exempt entity).
4. Mrs. Dhamala has paid Rs. 11,000 for life insurance premium.
5. Opening stock was undervalued by 10 percent.
6. Wages include private charge Rs. 20,000.
7. Allowable approved contribution to retirement fund was 10% of office staff salary.
8. General charges include fine Rs. 1,500 paid to local the government against violation of rules and Rs. 5,000 medical treatment expense of proprietors as approved by doctor's prescription.
9. Allowable depreciation was Rs. 29,000.
10. Proprietors used the purchased timber cost of Rs. 10,000 for firewood. He put his money as sales Rs. 12,000 in sales account against used timber however the prevailing market price of firewood was Rs. 11,500.

Required:

(a) Compute assessable income, statement of taxable income and tax liability of Mr. Dhamala. [10+3+3]

(b) Compute statement of taxable income and tax liability of Mrs. Dhamala. [3+2]

Solution:

Calculation of profit and gains and assessable income from business of Mr. Dhamala for income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
	INCLUSIONS	Amount	Amount
1	Income derived from disposal of trading stock	3,988,000	
2	Amount of compensation	70,000	
3	Interest income	75,000	
Total of inclusions		4,133,000	4,133,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	273,500	
2	Interest (§14)	50,000	
3	Cost of trading stock [w/n 2)	3,280,131	
4	R&I costs (§16)	20,000	
5	Depreciation allowance (§19)	29,000	
6	PC costs [w/n 3]	125,000	
Total of deductions		3,777,631	3,777,631
Business income			355,369
DEDUCTIBLE LOSS			-
Assessable income			355,369

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT

INCLUSIONS		**Amounts**	**Amount**
1	Interest income	75,000	
2	Income from house rent	25,000	
3	Income from natural resources	50,000	
Total of inclusions		150,000	150,000
Assessable income			150,000

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business	355,369
2	Assessable income from investment	150,000
Assessable income		505,369
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt organization	-
Taxable income		505,369
REDUCTION FROM TAXABLE INCOME		
	Reduction of individual limit	100,000

Taxable base		405,369
CALCULATION OF TAX LIABILITIES		
1.	Taxable base not exceeding Rs. 75,000 - 15 percent	11,250
2.	Taxable base in excess of Rs 75,000 - Rs 11,250 plus 25 percent of taxable base in excess of Rs 75,000 i.e. Rs. 330,000	82,500
CALCULATION OF ADDITIONAL TAX		
	1.5% of the taxable base of the Rs. 330,000	4,950
Tax liability before medical tax credit		98,700
MEDICAL TAX CREDIT		
	15% of cost or Rs. 750 whichever is lower	750
Tax liability		97,950

Working note:

1. General deductions

Particulars	Total	Non-ded.	Deductible
Staff salary	200,000	-	200,000
Approve retirement fund	25,000	5,000	20,000
Audit fee	15,000	-	15,000
Commission for raising loan	10,000		10,000
Bad debts	20,000	-	20,000
General charges	15,000	6,500	8,500
Total of general expenses	285,000	11,500	273,500

2. Cost of trading stock

	Opening Stock Add: amount of undervalued		250,000 27,778	277,778
Add:	Purchase Less: Timber used by proprietors Add: wages Less: private charge	2,500,000 (10,000) 800,000 (20,000)	2,490,000 780,000	3,270,000
Less:	Closing stock Less: loss of timber by flood		350,000 82,353	(267,647)
Cost of trading stock				3,280,131

3. Adjusted taxable income and PC cost

Total of inclusions			4,133,000
DEDUCTIONS:			
1	Interest (§14)	50,000	
2	Cost of trading stock (§15)	3,280,131	
3	R&I costs (§16)	20,000	
4	Depreciation allowance (§19)	29,000	

5	General deductions (§13)	273,500	3,652,631
Adjusted taxable income			480,369
50% of adjusted taxable income			240,184.5
Thus, debited PC cost Rs. 125,000 is deductible cost.			

Calculation of taxable income and tax liabilities of Mrs. Dhamala for the income year 2063/064

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME			
1	Assessable income from business	325,600	
2	Assessable income from investment	-	
Assessable income		325,600	325,600
DEDUCTION FROM ASSESSABLE INCOME			
	Donation to exempt organization	15,000	
Taxable income		310,600	310,600
REDUCTION FROM TAXABLE INCOME			
Reductions:			
1	Individual limit	100,000	
2	Life insurance premium	10,000	110,000
Taxable income [taxable base]			200,600

CALCULATION OF TAX LIABILITIES

1.	Taxable base not exceeding Rs 75,000 – 15%	11,250
2.	Taxable income in excess of Rs 75,000 - Rs 11,250 plus 25 percent of taxable base in excess of Rs 75,000 i.e. Rs. 125,600	31,400
CALCULATION OF ADDITIONAL TAX		
	1.5 % of the taxable base Rs. 125,600	1,884
Tax liability		44,534

REVIEW QUESTIONS AND CASES

1. The following statement has been extracted from the books of account of an Architect, Mr. Tuladhar.

Receipt and Payment Account

Receipts	Amount	Payments	Amount
To Opening balance	20,000	By Vehicle expenses	20,000
To Consultation fees	200,000	By Purchase of computer	60,000
To Visiting fees	50,000	By Salary to assistants	160,000
To Business income from other business	80,000	By life insurance premium	10,000
		By closing balance	100,000
	350,000		350,000

Further information:

1. Allowable depreciation for vehicle was Rs. 3,000.
2. Business income from other business was derived after adjusting the following expenses.
   a) Salary Rs. 3,000 p.m. was paid to his own son.
   b) Donation Rs. 10,000 was paid to Lions Club.
3. Life insurance premium was paid for policy Rs. 200,000 of his son.
4. Vehicle was used for his professional work only.

Required:

(a) Assessable income from business (profession)

(b) Statement of taxable income

(c) Tax liability [2×3]

[MBS, TU 2058, Modified]

2. Following is the summarized statement of cash concerning an Actor, Mr. Bhujel for the previous year.

Receipts and Payment Accounts

Receipts	Amount	Payment	Amount
To Balance of cash	450,000	By Purchase of car	300,000
To Advance receipt for singing	300,000	By Car expenses	75,000
To receipt from script playing	600,000	By Life insurance premium	10,000
To Rent from house let-out	150,000	By Salary to personal assistant	102,000
		By Donation to flood victims relief fund	10,000
		By Balance of cash	1,003,000
	1,500,000		1,500,000

Additional Information:

1. Car was purchased in Paush of previous year. It was used equally for both professional and personal work.
2. Dashain bonus to assistant equal to one-month salary has not been paid yet.

Required:

(a) Assessable income from business

(b) Statement of taxable income [4+2]

[MBS, TU 2061, Modified]

3. The given is the summarized statement of cash pertaining to an Artist:

Statement of Cash

Receipts	Amount	Payment	Amount
To Balance of cash	200,000	By Car purchased	400,000
To Receipt from script playing	400,000	By Car expenses	100,000
To Receipt from dance training program	100,000	By Salary to assistants	150,000
To Advisory fees	100,000	By Life insurance prem.	8,000
		By Donation to a local club	50,000
		By Balance of cash	92,000
	800,000		800,000

Further information:

1. Seventy-five percent of car expense was related to her professional job.
2. Life insurance premium was paid on a policy Rs. 100,000.
3. A compensation of Rs. 200,000 for the breach of contract from a producer has not been received yet. She incurred Rs. 30,000 as legal expenses to recover this amount.

Required:

(a) Assessable income from business

(b) Tax liabilities [4+2]

[MBS, TU, 2061, new course modified]

4. The following Receipts and Payments Account of a Housing Firm for previous year ending Ashadh

Receipts	Amount	Payment	Amount
To Balance of cash	50,000	By Office expenses	80,000
To Rent collected	800,000	By Property insurance	20,000
To Sale of a newly constructed house	1,000,000	By Donation to Lions Club	50,000
To Interest on bank deposit	20,000	By Loss on sale of car	20,000
		By Staff salaries	100,000
To Interest on other lending activities	30,000	By Advance tax	30,000
		By Vehicle expenses	20,000
To Sale of a car	100,000	By Cost of construction of disposed house	700,000
		By Miscellaneous exp.	200,000
		By Balance	780,000
	2,000,000		2,000,000

Additional information:

1. Staff salaries include Rs. 10,000 contributed towards unrecognized provident fund
2. Miscellaneous expenses include:
   (a) Legal fees Rs. 3,000;
   (b) Traveling expenses Rs. 5,000;
   (c) Repair Rs. 50,000;
   (d) Purchase of furniture Rs. 10,000 and
   (e) Vacancy allowance claimed Rs. 22,000 but Tax Office accepted only 50%.

Required:

Taxable income [taxable base] of the taxpayer [3+1+2]

[MBS, TU 2059, new course modified]

5. The following Cash Account shows the summarized statement of Receipts and Payments of Mr. Gautam, a Financial Analyst by profession, for the previous year.

Cash Account

Receipts	Amount	Payments	Amount
To Balance	50,000	By Purchase of car	100,000
To Consultation fees	200,000	By Life insurance premium (own)	5,000
To Visiting fees	50,000	By Vehicle expenses	50,000
To Net profit from business run by his son	100,000	By Salary to subordinates	30,000
To Sale of motorcycle	25,000	By Advance tax	60,000
		By Donation	10,000
		By Office expenses	30,000
		By Balance	140,000
	425,000		425,000

In a query made by the tax auditor the following facts were revealed:

1. Office expenses include Rs. 10,000 for purchase of office furniture.
2. Twenty percent of vehicle expenses meant for his business purpose.
3. Admissible depreciation for motorcar and office furniture was Rs. 150,000 and Rs. 2,000 respectively.
4. Business income was computed after adjusting the following expenditures:
   (a) Bad debts Rs. 20,000 but actual bad debts allowed were only Rs. 5,000;
   (b) Advance income tax Rs. 10,000;
   (c) Interest of Rs. 30,000 paid on a loan taken from a moneylender without registration and

(d) Salary Rs. 30,000 to his son and Rs. 30,000 to his helper.

Required:

(a) Assessable income

(b) Tax liabilities [3+3]

[MBS, TU 2059, new course modified]

6. The following Receipts and Payments account of a sole proprietorship firm of Mr. Kulkarni for the previous year.

Receipts	Amount	Payments	Amount
To Opening balance of cash	200,000	By Collection cost of interest	3,000
To Interest on private money lending activities	150,000	By Taxi charge	200
To Consultancy income	450,000	By Office rent	36,000
To Visiting fees	150,000	By Salary to assistant	320,000
To Royalty after withholding	170,000	By Legal expenses	5,000
To Interest after withholding	9,400	By Printing and stationery	50,000
To Royalty from books	30,000	By Donation to exempt organizations	65,000
To Amount received in lieu of accepting restriction on investment.	50,000	By Balance of cash	730,200
	1,209,400		1,209,400

Further information:

1. Collection cost of interest relates to private money lending activities.
2. Taxi was used to collect interest on fixed deposit.
3. Legal expenses relates to preparing legal documents concerning investment restriction.
4. Evidence against donation Rs. 2,000 could not be produced.

Required:

(a) Assessable income from business

(b) Assessable income from investment

(c) Statement of taxable income

(d) Tax liabilities [4+2+2+2]

[TU, MBS 2061, modified]

7. Given below is Receipts & Payments account of a medical practitioner, Mr. Rana for the relevant income year.

Receipts	Amount	Payments	Amount
To balance b/d		By rent of clinic	160,000
To consultation fees	187,000	By electricity and water	
To visiting fees	130,000	By purchase of ten	2,000
To loan from bank for		Professional books	8,000

professional purposes	525,000	By household expenses	7,800
To sale of medicine	173,000	By municipality taxes paid for property	2,000
To gift presents from patients	5,000	By purchase of car	316,000
To remuneration from article published in professional magazines	6,000	By fire insurance premium of property	200
To rent from house property	11,000	By surgical equipments	4,700
To interest on post office saving accounts	7,000	By advance income tax	13,000
		By salary and perquisite to assistants	112,000
		By entertainment	6,000
		By purchase of X-ray machine	100,000
		By expenses of income tax proceedings	15,000
		By life insurance prem.	15,000
		By gift to a lady	5,000
		By interest on loan	32,000
		By loan installment	50,000
		By donation to NCP (democratic)	50,000
		By car expenses	15,000
		By medicine purchase	80,000
		By balance c/d	85,300
	1,079,000		1,079,000

Compute his assessable income from profession, statement of taxable income and tax liabilities for the previous year. [5+2+1]

1. One-third of the car expense regards to the personal use.
2. Car was purchased at the end of Kartick of the previous year.
3. House property was let out for residential purpose for an individual.
4. Expenses on income tax proceeding include preparation of return of income of Rs. 1,000.
5. A receivable of consultancy fee for the year is Rs. 8,000.
6. Closing stock of medicines, in cost price was Rs. 8,000 however its current market price at the end of the year was Rs. 12,000.

8. The following is Income Statement of Mr. Kayastha, a resident of Nepal, for the previous year. Compute his assessable income, statement of taxable income and tax liability for the relevant year.[8]

Particulars	Amount	Particulars	Amount
Purchases	950,000	Sales less returns	1,572,500
Salaries and wages	350,000	Bad debts recovered allowed in earlier year	20,000
Trade expenses	9,000		
Registration of trade marks	2,000	Discount received	8,000

Rents, rates and taxes	12,500	Receipt from national	
Discount allowed	3,000	religious trust	20,000
Household expenses	8,500	Refund of income tax	10,000
Advertisement expenses	55,000	Proceedings of life	
Income tax	10,000	insurance policy	115,700
Value added tax paid	5,000		
Expenditure on known-how	32,000		
R&D cost	25,000		
Contribution to a trust for	8,000		
Staff welfare expenses	4,000		
OYT deposit	5,000		
Office rent	6,000		
Donation to a school	6,000		
Life insurance premium	4,000		
Interest on capital	8,000		
Interest on loan	8,000		
Wealth tax	500		
Gift tax	1,000		
Audit fee	3,000		
PC costs	30,000		
Gift to consumers	4,000		
Appreciation expenses	1,500		
Emergency risk insurance	6,000		
Fine & penalty of telephone	1,200		
Provision for bad debts	6,000		
Reserve for pecuniary losses	6,000		
Net profit	176,000		
	1,746,200		1,746,200

Additional information:

1. Household expenses include Tiffin expense of staffs of Rs. 1,000.
2. Proceedings of life insurance policy include miscellaneous income Rs. 15,700 of the firm.
3. Rents, rates and taxes include income tax Rs. 1,500.
4. Allowable depreciation allowance was Rs. 36,500.
5. Appreciation expenses relate gift to proprietor's wife. She is instructor in the firm and receives salary Rs. 5,000 per month however her salary is not mentioned in the above statement.
6. Interest on loan refers loan taken to pay income tax for the previous year.

9. Mr.Khanal, a manpower supplier to Malaysia presented the following Income Statement for the previous year.

Particulars	Amount	Particulars	Amount
General office expenses	32,000	Manpower supplied	
Staff salary	351,000	income:	
Telephone and fax	135,000	(a) Cash received	450,000
Airfare	76,000	(b) Receivable	550,000
Hotel charges of clients	22,000	Net gain from disposal	
Purchase of air conditioner	120,000	of business liabilities	58,000
Printing and stationery	12,000	Miscellaneous income	25,000
Government rates	40,000	Rent of the house	125,000
Clients training charges	35,000	Interest income from	
Guest and hospitality	13,000	fixed deposit	50,000
Rent expenses	120,000	Amount received for	
Conveyance	8,000	accepting a restriction	
Water and electricity	15,000	to supply the man-	
Entertainment charge	8,000	Power to Gulf countries	150,000
Newspaper and bulletin	26,000		
Guard salary	48,000		
Commission	25,000		
Lawyer charges	30,000		
Depreciation	42,000		
Net profit	250,000		
	1,408,000		1,408,000

Mr. Khanal disclosed the following additional information:

1. Miscellaneous income includes income of sale of old newspaper Rs. 10,000 and rent income of computer Rs. 15,000.
2. Staff salary includes salary of the proprietor's wife Rs. 16,000.
3. Commission was paid to government officials in under table to get permission for Mauritius.
4. Water and electricity tariff was paid for the whole house however his business occupies one-third of his building.
5. Rent expense was made for the proprietor's house.
6. Airfare includes both airfares of proprietors and client equally.
7. Lawyer charge was incurred to defend case of income tax Rs. 10,000 and to defend case taken money not to pay client Rs. 20,000.

Required:

(a) Assessable income from business

(b) Statement of taxable income

(c) Tax liabilities [5+2+1]

10. Mr. Thapa, a furniture maker furnished the following Income Statement for the relevant income year.

Particulars	Amount	Particulars	Amount
Opening balance	165,000	Furniture sales	2,630,000
Purchase of wood	1,150,000	Scrap sales	20,000
Wages to worker	350,000	Closing stock	190,000
Purchase of color, pins etc.	90,000		
Wastage of wood	42,000		
Gross profit	1,043,000		
	2,840,000		2,840,000
Salary to staffs	240,000	Gross profit	1,043,000
Telephone and fax	18,000	Interest income	9,000
Guest and hospitality	12,000	Rent of machinery	40,000
Rent of factory space	72,000	Windfall gain	3,000
Municipality tax	3,000		
R&I cost of machine	13,000		
PC costs	103,000		
Water and electricity	40,000		
Worker Tiffin	22,000		
Depreciation	35,000		
Net profit	537,000		
	1,095,000		1,095,000

Mr. Thapa presented the following information:

1. He has maintained his account adopting accrual and cash basis accounting methods 惘 incomes and expenses are accrual and cash basis respectively. The following amounts are yet due that are not mentioned in the above statement.
   (a) Wages to worker Rs. 105,000,
   (b) Purchase of wood Rs. 250,000,
   (c) Salary to staff Rs. 15,000,
   (d) Donation to local club Rs. 3,500 and
   (e) Life insurance premium Rs. 10,500.
2. Interest income was received from fixed deposit.
3. Allowable depreciation allowance was Rs. 38,000.
4. Municipality tax was paid to hang sign board on road side.
5. Electricity expenses of Rs. 36,000 relate to make furniture.
6. Telephone and fax expenses include STD call charge to his old house of Nuwakot.

Required:

(a) Assessable income from business [5]

(b) Statement of taxable income and tax liabilities [2+1]

11. Mr. Baranwal, a Gold Smith stated the following Income Statement for the relevant income year.

Particulars	Amount	Particulars	Amount
Opening balance	149,112,121	Dealership sales	564,127,019
Purchase of goods	569,123,876	Retail sales	48,316,873
Purchase related expenses	29,217,824	Closing stock	169,950,250
Electricity charges	465,734		
Fuel expenses	291,372		
Salary to artists and labor	2,039,867		
Promotional	319,974		
Gross profit	31,823,374		
	782,394,142		782,394,142
Salary to marketing staffs	414,017	Gross profit	31,823,374
Office staff	380,500	Income from extra-ordinary items	37,550
Staff's medical expenses	17,019		
Tiffin to worker & staffs	306,002		
Telephone and fax	325,490		
Insurance premium	19,083		
Conveyance / vehicle fuel	73,578		
Auditor's remuneration	35,000		
Bank charges	26,816		
Donation	30,300		
Guest and hospitality	145,321		
Worship expenses	61,000		
Miscellaneous expenses	79,134		
Newspaper and bulletin	8,235		
Printing and stationery	71,542		
Traveling expenses	123,846		
R&I cost of vehicles	52,015		
Financial cost	7,269,635		
Depreciation	2,524,244		
Net profit	19,849,753		
	31,860,924		31,860,924

Mr. Baranwal revealed the following information:

1. Opening stocks was overvalued by 5 percent while closing stock was undervalued by 10 percent.
2. Purchase includes ornament purchase of proprietor's family of Rs. 2,021,500.

3. Electricity charge includes personal and domestic expense of taxpayer of Rs. 22,500.
4. Tiffin to workers and staffs includes discount made to his relatives in ornament purchase.
5. Auditor's remuneration regards for financial audit Rs. 15,000 and tax audit Rs. 10,000.
6. Donation was made to ethnic trust of Manka Khalah.
7. Worship expenses include the following:
   (a) Worship of Laxmi Rs. 21,000
   (b) Worship of Dakshin Kali God Rs. 30,000. It was celebrated on Dashain with Pancha Bali.
   (c) Wedding expenses of sibling nephew Rs. 10,000.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [5+2+1]

12. The firm of M/s Maharjan & Associates is engaged in the business of growing and manufacturing tea. The shortened Income Statement of the previous year is as given below:

Income Statement

Particulars	Amount	Particulars	Amount
Opening balance	1,150,000	Sales	10,096,000
Cost of growing and manufacturing tea	5,000,000	Rent from staff quarter	250,000
Salary and wages	1,500,000	Interest income	150,000
Advertising	600,000	Closing stock	1,550,000
General expenses	200,000		
Telephone and fax	25,000		
Traveling expenses	300,000		
Fine and penalties	30,000		
Auditors remuneration	5,000		
Cost of patent rights	900,000		
Donation	30,000		
R&D costs	1,400,000		
Depreciation	61,000		
Net Profit	445,000		
	11,646,000		11,646,000

The firm disclosed the following information:

1. Advertising includes payment of loan taken from relatives Rs. 150,000. It was 10% loan however prevailing market practice for such type of loan was seven and half percent.
2. Traveling expenses were:
   (a) Traveling to Japan to search part for exporting tea Rs. 150,000.

(b) To visit his uncle in Bombay Rs. 50,000.
(c) To sell tea in Jumla Rs. 50,000.
(d) To collect creditors in different part of Nepal Rs. 50,000.

3. General expenses were: (a) Rs. 50,000 for promoting the business. (b) Rs. 100,000 for consulting new technology of tea plantation. (c) Rs. 50,000 for making web page relating to tea business.
4. Interest income was:
   (a) Rs. 75,000 from domestic money lending.
   (b) Rs. 75,000 from staff lending. The interest rate of the loan 10% however the market practice for such type of loan was 15%.
5. Fine and penalties were paid for violation of local government rules.
6. Salary and wages include payment made to workers Rs. 1,000,000 they were directly involved in tea production.

Required:

(a) Assessable income from business [5]
(b) Statement of taxable income and tax liabilities [2+1]

10.8 PARTNERSHIP BUSINESS

Partnership is an association of two or more persons to carry on as co-owners a business for profit. The partnership firm runs according to partnership deed. It establishes rights and duties between the partners and regulates their conduct as they transact business. About partnership firm Encarta (2007) states:

> Partnership, in law, term applied to an association of two or more people who have agreed to combine their labour, property, and skill, or some or all of them, for the purpose of engaging in lawful business and sharing profits and losses between them; in this definition the term business includes every trade, occupation, and profession. The parties forming such an association are known as partners. Partners may adopt a fictitious name or use a real family name which must be registered.
>
> Partnership can be formed only by contract. Any number of people may contract to form a partnership, and firms of partners may enter into partnership with one another. New members may be admitted into an existing partnership only with the consent of all the partners. The agreement of partnership is generally for a definite period of time or for a limited project; if no duration is specified, it is said to be a partnership at will, and can be terminated at any time by any partner. By the agreement of members, a partnership may be dissolved or terminated and the terms of the partnership agreement modified at any time. Death or bankruptcy of a partner, the insanity or misconduct of a partner, and the end of the period fixed for the duration of the partnership also operate to terminate the partnership.

Partnership is defined by the Indian Partnership Act, 1932, as 'the relation between persons who have agreed to share profits of the business carried on by all or any of them acting for all'. This definition gives three minimum requirements to constitute a partnership, those are:

1. There must be an agreement entered into orally or in writing by the persons who desire to form a partnership,
2. The object of the agreement must be to share the profits of business intended to be carried on by the partnership, and
3. The business must be carried on by all the partners or by any of them acting for all of them.

In Nepal, a source of partnership firm has been codified in Partnership Act, 1964 (2020). According to the Act, no statutory filing needs to form and operate a partnership. However, it needs partnership deed that assists

individuals in creating and defining the relationship between the partners. It can also be a useful reference when the partnership agreement is silent on a particular topic.

Partnership may be created by a verbal agreement, however, it is customary and recommended that the partners define their rights and duties in a written agreement. It is also known as partnership deed. According to Partnership Act 1964, a partnership firm is to register within six month at concerned department after its presence involving its partners. Application for registration requires:

1. Full name of partnership firm;
2. Main address of partnership firm;
3. Product and service name of transaction;
4. Objectives of partnership firm;
5. Full name, caste, permanent address of partners;
6. Any restriction of power to any partners if any;
7. Types of partners and capital carried by each partners;
8. Representative partner of the partnership firm or name of the partners;
9. Method of allottment of profit and loss;
10. Method of determining profit;
11. Others if necessary as required by concerned authority.

Property of the partnership belongs to its firm and denotes initial invested capital including goodwill and acquired property in course of business. The partners of the firm can obtain remuneration. Moreover, partners can get interest not exceeding 10 percent per annum if invested additional loan capital to the firm by partners according to partnership deed.

According to Partnership Firm Act 2020, there is simply partnership firm. But, ITA 2002 assumes two types of partnership firm: partnership firm and partnership firm with more than 20 partners.

In western countries, there are two types of partnership firm: limited liability and unlimited liability partnership firms. In England, the Partnership Act of 1907 governs the limited partnership. It consists of general partners who are the main partners with exclusive right of management and their liability is unlimited. But they can take any limited partner who contributes some capital to the Firm and whose liability is limited to that amount provided. He does not participate in the management or withdraw any part of the capital contributed by him

during the term of partnership. However, a limited partnership is not a separate legal entity like a limited company. Generally, a limited partner joins a firm to participate in a particular scheme or adventure of the firm.

Partnership Firm with less than 20 partners denotes unlimited partnership firm. Whose liability may be joint and unlimited when they are established which depends upon the circumstances. Partnership Firm with more than 20 partners in Nepal is treated as a company. It denotes limited liability partnership and liability limited to the extent of their capital investment.

Specially, partnership firm is operated by the partnership deed. A partnership firm may involve different types of partners: silent or sleeping and active. A silent partner is one who still shares in the profits and losses of the business, but who is not involved in its management, and/or whose association with the business is not publicly known.

Partnership firm has the following advantages:

1. Partnership needs few legal requirements. Partnership deed not compulsory but advised to attach. It does not require many State filing.
2. Partners may pool their resources and talents. It provides control and participation equally in management.
3. A partnership has flow-through taxation meaning the partnership does not pay taxes. Instead, the individual partners are taxed on the income they receive from the partnership. However, in Nepal, it is under conflict as provision laid down in §54(2). In Nepal, partnership firm is taxed by corporate tax.
4. Profits and losses are divided among partners in any manner they choose.
5. Under a partnership, assets of any of the partners can be used to cover the business's liabilities, regardless of which partner incurred the liability.

Partnership firm has the following disadvantages

1. Partners have unlimited liability in a partnership business firm.
2. Firm may be closed due to misunderstanding between partners.
3. All partners are jointly and severely liable for all obligations
4. Ownership transfer depends upon the partnership agreement

CASES AND SOLUTIONS

1. Given below is Income Statement of Nut & Bolt Partnership Firm for the previous year

Particulars	Amount	Particulars	Amount
Opening stock	150,000	Sales income	7,354,000
Purchases	5,320,000	Closing stock	249,500
Purchasing expenses	385,000		
Sales return	15,000		
Freight and insurance	160,000		
Local development fee	80,000		
Gross profit	1,493,500		
	7,603,500		7,603,500
Salaries	450,000	Gross profit	1,493,500
PC costs	366,000	Rent from staff quarters	37,500
Audit fee	35,000	Amount of gifts	50,000
Legal expenses	30,000	Interest income	35,000
R&I cost of office equip.	128,000	Miscellaneous incomes	450,000
Loss from business assets	20,000		
Bad debts	16,000		
Staff welfare expenses	15,000		
Compensation	260,000		
Interest	250,000		
Distribution of profit	100,000		
Doubtful debt provision	25,000		
Depreciation	190,000		
Donation to exempt entity	130,000		
Net profit	51,000		
	2,066,000		2,066,000

Additional Information:

1. Freight and insurance includes fine paid to local government of Rs. 5,000.
2. Legal expenses include income tax of Rs. 5,000 and legal expenses of partner's vehicle of Rs. 10,000.
3. Miscellaneous income includes the following income:
   (a) Accepting a restriction for marketing in a particular place Rs.250,000
   (b) Compensation on breach of contract sales Rs. 100,000

(c) Bad debts recovered Rs. 100,000 where 50 percent of the bad debts were not allowed previously.

4. Compensation expenses were paid against breach of contract sales to protect further future losses.
5. Interest includes the following interests.
   (a) Interest for partners capital Rs. 50,000
   (b) Interest paid to bank loan for working capital Rs. 100,000
   (c) Interest for partners loan Rs. 50,000
   (d) Interest for delay payment of credit purchase Rs. 50,000

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liability [10+2+4]

Solution:

Calculation of profit and gains and assessable income from business of Nut & Bolt Partnership Firm for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		**Amounts**	**Amounts**
1	Amount derived from disposal of trading stock	7,339,000	
2	Amounts derived from investments that are directly connected with the business[2]	72,500	
3	Gift received in relation to the business	50,000	
4	Amount derived from accepting a condition regarding business	250,000	
5	Amount of compensation	100,000	
6	Bad debts recovered remitted in earlier income year	50,000	
Total inclusions		7,861,500	7,861,500
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	791,000	
2	Interest expenses	200,000	
3	Cost of trading stock [w/n 2]	5,840,500	
4	R&I costs	128,000	
5	Depreciation allowance	190,000	
6	PC costs [w/n 3]	356,000	

[2] Total of two items: rent from staff quarters Rs. 37,500 and interest income Rs. 35,000.

Total of deductions	7,505,500	7,505,500
Business income		356,000
DEDUCTIBLE LOSSES		-
Assessable income		356,000

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from business	356,000
Assessable income		356,000
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt entity (5%×712,000)	35,600
Taxable income		320,400

CALCULATION OF TAX LIABILITIES

Taxable income	320,400
Taxable income Rs. 320,400 @ 25 percent	80,100

CALCULATION OF ADDITIONAL TAX

1.5% of the taxable income Rs. 320,400	4,806
Tax liabilities	84,906

Working Note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Salaries	450,000		450,000
2	Audit fee	35,000		35,000
3	Legal expenses	30,000	15,000	15,000
4	Bad debts	16,000		16,000
5	Staff welfare	15,000		15,000
6	Compensation	260,000		260,000
Total		806,000	15,000	791,000

2. Cost of trading stock

Cost of trading stock			**Amounts**
Opening stock			150,000
Add	Purchase	5,320,000	5,940,000
	Purchase expenses	385,000	
	Freight and insurance	155,000	
	Local development fee	80,000	
Less	Closing stock		249,500

Cost of trading stock	5,840,500

3. **Calculation of PC costs**

1	Total of inclusion from business		7,861,500
Deductions:			
1	General deductions [w/n 1]	791,000	
2	Interest	200,000	
3	Cost of trading stock [w/n 2]	5,840,500	
4	R&I costs	128,000	
5	Depreciation allowances	190,000	7,149,500
Adjustable taxable income			712,000
	50% of the adjusted taxable income		356,000
	PC costs incurred during the year		366,000
Thus, deductible PC cost is Rs. 356,000			

Clarification:

1. Fine and penalty paid to central or local government against violation of rules and regulation is not deductible amount.
2. Loss from disposal of business assets is capital loss. It can reduce from gain of disposal of business assets and liabilities but can not reduce from business income.
3. Distribution of profit relates profit taken by the partners of the firm and it is taken as distribution by the entity. So, distribution of the profits to its beneficiary is not deductible amount.
4. All and any type of provisions made by business organization are not deductible amounts.
5. R&I cost has to deduct as debited amount in absence of depreciable base for the comparison.
6. Partners of partnership firm can get profit after payment of income tax and it is reduced from (by) earned profit only.
7. Partners of partnership firm cannot draw interest for their partnership capital.

2. Given below is Income Statement of Scope Consultancy, a partnership firm for the relevant previous year.

Particulars	**Amount**	**Particulars**	**Amount**
Consultants salary	5,060,000	Consultancy income	18,050,900
Report reproduction	1,215,000	Visiting income	550,000
Daily service allowance	1,100,000	Reporting income	650,000
Airfare/transportation	1,860,000	Net gain from disposal	
Advertisement expenses	250,000	of business liabilities	93,500
Staff salaries	1,710,000	Interest income	30,000

R&D costs	1,300,000	Sundry income	5,000
Financial audit fee	25,000	Bad debts recovered	40,000
Tax assessment fee	50,000		
Legal expenses	70,000		
Interest	450,000		
R&I cost	80,000		
Fine expenses	56,000		
Local transportation	25,000		
Tiffin expenses	150,000		
Inquiry expenses	25,000		
Telephone and fax	490,000		
Amount of sick leave	50,000		
Provision for future loss	290,000		
Depreciation allowance	625,000		
Donation - exempt entity	105,000		
Loan commitment fee	30,000		
Office rent	120,000		
Commission expenses	50,000		
Net profit	4,233,400		
	19,419,400		19,419,400

Scope Consultancy disclosed the following additional information:

1. Advertisement expenses include legal expense of a partner for filing a case in the Court Rs. 50,000.
2. A sum of Rs. 250,000 of report reporduction was paid on cash at once charce.
3. Office rent was paid without withholding.
4. Inquiry expenses were made for the inquiry of the new business.
5. 50 percent of the tiffin expenses were personal expenses of the partners.
6. Fine expenses were of following nature:
   (a) Delay payment of telephone charges Rs. 12,000
   (b) Voilating the local government rules Rs. 13,000
   (c) Delay submission of consultancy report as to contract Rs. 31,000
7. Commission expenses were briberies to government officials to get the consultancy.
8. Rs. 90,000 donation was on credit to pay the following year.
9. 50 percent of the legal expenses were lawyer expenses related to tax appeal and rest was to defend title of the assets of the company.

Required:

(a) Assessable income from business
(b) Statement of taxable income

(c) Tax liabilities [10+3+2]

Solution:

Calculation of profit and gains and assessable income from business of Scope Consultancy Partnership Firm for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		**Amounts**	**Amounts**
1	Service fees (a) Consultancy income 18,050,900 (b) Visiting income 550,000 (c) Reporting income 650,000	19,250,900	
2	Net gain from disposal of business Liabilities of the person	93,500	
3	Amount derived from investment effectively connected with business	30,000	
4	Bad debts recovered remitted in earlier income year	40,000	
5	Other amounts (sundry income)	5,000	
Total inclusions		19,419,400	19,419,400
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	11,901,000	
2	Interest expenses	450,000	
3	R&I costs	80,000	
4	Depreciation allowance	625,000	
5	R&D costs [w/n 2]	1,300,000	
Total of deductions		14,356,000	14,356,000
Business income			5,063,400
DEDUCTIBLE LOSSES			-
Assessable income			5,063,400

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from business	5,063,400
Assessable income		5,063,400
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt organization	15,000
Taxable income		5,048,400

CALCULATION OF TAX LIABILITIES

Taxable base/taxable income		5,048,400
1	Taxable income Rs. 5,048,400 @ 25 percent	1,265,850

CALCULATION OF ADDITIONAL TAX

2	1.5% of the taxable income of Rs. 5,048,400	75,726
Tax liabilities		1,341,576

Working Note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-ded.	Deductible
1	Consultants' salary	5,060,000		5,060,000
2	Report and reproduction costs	1,215,000	250,000	965,000
3	Daily service allowance	1,100,000		1,100,000
4	Airfare and transportation charge	1,860,000		1,860,000
5	Advertisement expenses	250,000	50,000	200,000
6	Staff salaries	1,710,000		1,710,000
7	Financial audit fee	25,000		25,000
8	Tax assessment fee	50,000	35,000	50,000
9	Legal expenses	70,000		35,000
10	Fine expenses	56,000	25,000	31,000
11	Local transportation	25,000		25,000
12	Tiffin expenses	150,000	75,000	75,000
13	Inquiry expenses	25,000		25,000
14	Telephone and fax	490,000		490,000
15	Amount of sick leave	50,000		50,000
16	Loan commitment charge	30,000		30,000
17	Office rent	120,000		120,000
18	Commission expenses	50,000		50,000
	Total	12,336,000	435,000	11,901,000

2. Calculation of R&D costs

1	Total of inclusion from business		19,419,400
Deductions:			
1	General deductions [w/n 1]	11,901,000	
2	Interest expenses	450,000	
3	Repair and improvement costs	80,000	
4	Depreciation allowances	625,000	13,056,000
Adjustable taxable income			6,363,400
	50% of the adjusted taxable income		3,181,700
	R&D costs incurred during the year		1,300,000
Thus, deductible cost of R&D is Rs. 1,300,000			

Clarification:

1. Payment of donation is not deductible on credit basis.

2. Fine for delay completion or submission of work is deductible amount.

REVIEW QUESTIONS AND CASES

1. ITA 2002 overrides provisions of Partnership Act 2020. Explain.
2. Partnership Firms are taxed by corporate tax. Is it equitable?
3. Do you feel necessity of separate provision of income tax for partnership firm? Explain.
4. Write a critical note about net gain from disposal of assets and liabilities of the partnership firm.
5. M/S Ram & Lal Partnership Firm presented the following Income Statement for the previous year.

Expenses	Amount	Income	Amount
Purchases	1,300,000	Sales	2,588,000
Salary and commission	880,000	Interest on drawing	7,000
Rent, rates and taxes	50,000	Gross dividend	120,000
Depreciation	20,000	Closing stock	50,000
Traveling expense	250,000		
Interest on capital	25,000		
Entertainment	60,000		
PC costs	120,000		
Net profit	60,000		
	2,765,000		2,765,000

Management representations letter of the firm clerify the following points:

1. Salary & commission include salary to Ram (partner) Rs. 10,000 p.m.
2. Traveling expense includes visit of Lal to Bombay, Dubai and Malaysia by air for the purpose of business of 15 days. The incurred expenses consist: air fare is Rs. 105,000; accommodation expenses Rs. 60,000; daily allowance 22,500 and balance incurred for his personal purposes.
3. Entertainment expenses includes the following:
   (a) A payment of hoarding board of the firm Rs. 25,000.
   (b) A gift to the ceremony of Lal's daughter Rs. 5,000.
   (c) Cost of picnic operated by the firm to the all employees on the occasion of anniversery day of the firm Rs. 30,000.
4. Permissible depreciation as per ITA 2002 was Rs. 19,500.
5. Closing stock has been always valued at market price. This year it has been value at cost price which is less than 25 percent of the market price.
6. Dividend income includes the following:

(a) Fifty percent of dividend was received from Co-operative Society Limited. Transactions of the Limited based on agriculture seeds and pesticide.
(b) Dividend sum of Rs. 12,500 was received from Private Limited Company where the firm holds fifty percent its shares.
(c) 25 percent dividend income was received from non-resident company.

Required:
(a) Assessable income
(b) Tax liabilities [6+2]

6. M/S Baranwal & Sirohiya Firm presented the following Income Statement for the previous year.

Particulars	Amount	Particulars	Amount
Purchase	1,200,000	Sales	2,175,000
Salary and wages	400,000	Refund of income tax and tax penalty	15,000
Rent of business premises owned by partner (Baranwal)	50,000	Rent of staff quater	100,000
R&I cost of business premises	40,000	Gain from business assets before deduction of loss on depreciable assets Rs. 15,000	375,000
Insurance premium of business premises	5,000		
R&D costs	200,000	Interest on drawing	10,000
Establishment expense	300,000	Closing stock	25,000
Municipality taxes of staff quarter owned by partnership firm	10,000		
Bad debts provision	60,000		
General reserve	100,000		
Interest on capital	35,000		
Net profit	300,000		
	2,700,000		2,700,000

Additional information:
1. Salary and wages include:
(a) Salary of Sirohiya Rs. 40,000
(b) Salary to spouse of Mr. Baranwal Rs. 60,000
(c) Profit shared by the partners against their capital investment as interim profit sharing.

(d) Normal staff salary Rs. 200,000
2. Fifty percent rent was paid for the next year.
3. Refund of income tax includes:
   (a) Income tax Rs. 10,000 and
   (b) Income tax penalty Rs. 5,000.
4. Sales include commission income Rs. 250,000.
5. Bad debts provision includes bad debts Rs. 20,000 and provision Rs. 40,000.
6. Closing stock is valued at cost price and its market price is 10 percent higher than cost price.
7. Purchase includes opening stock Rs. 30,000 which was based on market price. Cost price of the opening balance was 10 percent lower than prevailing market price.

Required:

(a) Assessable income
(b) Tax liabilities [6+2]

7. The firm of M/s Three Leaves Tea is engaged in the business of growing and manufacturing tea. The abridged income statement for the previous year is given as below:

Particulars	Amount	Particulars	Amount
Cost of growing and manufacturing tea	6,000,000	Sales	15,000,000
Salaries and wages	2,000,000	Closing stock	2,700,000
Advertising	1,000,000		
Entertainment	200,000		
Traveling	300,000		
Fine and penalties	100,000		
Costs of patent right	1,400,000		
R&D costs	1,000,000		
PC costs	2,000,000		
General expenses	700,000		
Net profit	3,000,000		
	17,700,000		17,700,000

The partners further informed that:

1. Advertising includes personal expenses of the partners Rs. 20,000.
2. Entertainment expenses include capital expenses of Rs. 80,000.
3. General expenses include:

   (a) Auditor's remuneration including tax audit Rs. 25,000
   (b) Printing and stationary including heavy punching machine (of Rs. 5,000) total Rs. 38,000.

(c) Rent expenses of brach office situated in Kathmandu Valley Rs. 150,000.
(d) Cloth expenses of the staff Rs. 125,000. The uniforms were fit for use for outside work too.
(e) Conveyance expenses of Rs. 62,000.
(f) Fuel expenses of vehicles 250,000
(g) Medical treatment expenses of workers, staffs including manager Rs. 50,000.

4. 25 percent of salary was profit sharing between two partners in equal basis.
5. Fine and penalties include:
   (a) Fine and penalty of breach of contract of Rs. 20,000. The breach of contract was beneficial to protect the future loss.
   (b) Payment of income tax to the IRO against draw of a case of income tax Rs. 80,000.
6. Closing stock includes compensation of Rs. 50,000. It was unintentionly mistake.
7. Amount of permissible depreciation was Rs. 150,000.

Required:

(a) Assessable income
(b) Tax liabilities [6+2]

8. The following is Income Statement of XYZ Cinema Hall (partnership firm) for the previous year.

Particulars	Amount	Particulars	Amount
Carbon purchase	456,150	Income from	
Fuel and energy	296,700	entrance fee	12,400,280
Disposal electric goods	22,350	Amount derived from	
Hire charge of films	1,350,000	accepting a condition	
Advertisement	426,800	of restriction	200,000
Poster expenses	9,000	Compensation income	50,000
Ticket printing	103,500		
Water and electricity	1,568,000		
Gross profit	8,417,780		
	12,650,280		12,650,280
Auditor's fee	25,000	Gross profit	8,417,780
Communication	291,560	Slide show income	150,500
Conveyance	22,340	Indoor shopping	
Donation	130,000	rent income before	
Festival expenses	26,400	withholding	126,000

Entertainment	64,500	Shutter rent income	
Miscellaneous expenses	268,760	after withholding	385,000
Newspaper and bulletin	43,567	Other income	43,200
Printing and stationery	50,600		
Staff medical expenses	33,000		
Staff uniform	24,000		
Staff salary	1,480,000		
PC costs	1,860,000		
R&I costs	445,000		
Depreciation allowances	3,650,250		
Net profit	707,503		
	9,122,480		9,122,480

For the tax assessment, partners furnished the following additional information:

1. A proper adjustment is to be needed to determine consumption cost of carbon for the year due to not accounting properly.
   (a) Opening balance of carbon was Rs. 24,690
   (b) Closing stocks of carbon was Rs. 2,430
   (c) According to stock ledger, 90 sticks of carbon were borrowed from another hall, those are not refunded yet. The amount of borrowed carbon was not mentioned in purchase account; it costs Rs. 32 per stick.

2. Hire charges and entrance fee of ongoing film of the halls:

Hall	Films	Hire charges of films		Entrance fee collection	
		Paid in Ashadh of the previous year	Paid in Srawan of the following year	Collection in Ashadh	Collection up to the following year
A	Nepali	45,000	-	60,000	135,000
B	Hindi	-	80,000	35,000	210,000
C	English	40,000	40,000	30,000	90,000

As shown in the above table the hire charges of those films have to be adjusted as to their earnings.

3. Communication includes/excludes the following:
   (a) Fine for delay payment of telephone charges Rs. 3,200
   (b) The telephone charge, a sum of Rs. 8,200 of Jestha - Ashadh was paid in the following year.
4. Other income includes outside liabilities Rs. 10,200.

5. Depreciation allowance includes loss from disposal of depreciable assets Rs. 55,000.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

9. Given below is Income Statement of Bhola & Shanker Consultancy Firm for the previous year.

Particulars	Amount	Particulars	Amount
Salary to other consultants	1,525,000	Consultancy income	2,550,000
		Visiting income	118,000
Rental expenses	69,000	Gift from client	62,000
Report reproduction	25,000	Bad debts recovered	40,000
R&I costs	27,000	Compensation amount	50,000
Office expenses	34,000	Interest income from bank	47,000
Reserve for B&D	16,000		
Donations	24,000	Interest income from individual	47,000
Depreciation	170,000		
Income tax provision	150,000		
Telephone and faxes	56,000		
Loan commitment charge	29,000		
Consultant training	130,000		
Entertainment	25,000		
R&D costs	243,000		
Gift to partners	60,000		
Net profit	331,000		
	2,914,000		2,914,000

Additional information:

1. Consultancy income was as to bank statements. The firm neither has adjusted withholding amount in income nor claimed withholding as an advance.
2. Seventy-five percent bad debts are allowed previously.
3. Salary to other consultants induces salary paid to domestic servant of the partners Rs. 50,000.
4. Rental expenses include rent of Rs. 60,000 and withholding of the rent Rs. 9,000.

5. Payment of loan commitment charge concerns charge of loan to be taken in the following year.
6. Fifty percent consultant training expenses were not concerned firm expenses.
7. Miscellaneous income of Rs. 50,000 and its actual expenses of Rs. 15,000 are not recorded in the above statement.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [10+2+4]

10. Building Builders, a partnership firm of Nepal has been awarded a big contract to construct national highways, bridges, assembly and installation of plant and machinery in Bangladesh. The firm has presented the following Income Statement for the previous year.

Particulars	Amount	Particulars	Amount
Building Material	2,000,000	Value of work certified	5,600,000
Salaries and wages	1,200,000	Cost of work uncertified	1,000,000
Establishment expenses	800,000	Material at side	200,000
Sundry expenses	400,000		
Depreciation	200,000		
Advance income tax	400,000		
Foreign project reserve account	580,000		
R&D costs	500,000		
Bad debts	20,000		
Net profit	700,000		
	6,800,000		6,800,000

Additional information:

1. Net gain from disposal of business assets was Rs. 200,000 that is not mentioned in the above statement.
2. Carried forward of business loss from the previous year is Rs. 1,200,000 including the loss of Bangaladesh project Rs. 400,000.
3. Sundry expenses include commission expenses Rs. 75,000 that was paid without withholding.

Required:

(a) Assessable income

(b) Tax liabilities [6+2]

11. The following is Income Statement of Sen & Khan, a partnership firm for the previous year.

Particulars	Amount	Particulars	Amount
Purchase	1,700,000	Sales	3,318,000
Salaries and bonus	880,000	Interest on drawings	125,000
Rent, rates and taxes	150,000	Dividend from	
Depreciation	120,000	non-resident company	46,000
Traveling expenses	175,000	Miscellaneous income	50,000
Interest on partner's capital	50,000		
R&I costs	90,000		
Entertainment expenses	50,000		
Advertisement	150,000		
Net profit	173,000		
	3,538,000		3,538,000

Assessor is further informed that:

1. Salaries and bonus includes salary to a partner Rs. 90,000.
2. Traveling expenses include visit of partners to Bhairahawa and Pokhara by air for business purposes for 30 days. Air fare is Rs. 60,000 and other expenses including hotel bills Rs. 115,000.
3. Depreciation permissible as per ITA, 2002 is Rs. 102,000.
4. Closing stock has been always valued at market price. However, this year it has been valued at cost price which is less than 15 percent of the market price.
5. Miscellaneous income includes the following incomes:
   (a) Refund of income tax Rs. 5,000
   (b) Bad debts recovered Rs. 25,000. 50% of bad debts were remitted in earlier income years.
   (c) Sales of old news paper Rs. 3,000
   (d) Income from natural resources Rs. 17,000
6. Advertisement includes the following expenses:
   (a) A hoarding bill paid in cash at once time Rs. 50,000.
   (b) Donation to a public high school (exempt) entity Rs. 10,000.
   (c) Rs. 90,000 was paid to Kantipur Publication in lieu of advertisement published in daily newspaper.

Required:

(a) Assessable income from business

(b) Statement of taxable income

(c) Tax liabilities [10+2+4]

10.9 COMPANIES

Company is an association of persons, formed for some common purposes and registered according to the laws related to the company. In other words, it is a voluntary association of persons created by law, usually to carry on some business for profit, with perpetual succession and common seal, i.e. a company is an artificial person, invisible, intangible and existing only in contemplation of law. However, one must remember that companies may also be formed for the promotion of commerce, art, science, religion or charity or any other useful object under the Company Act. In recent year, Lord Justice Lindley (as cited in Paul, 1996) defines:

> By a company is meant an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share.

The above stated definition of company belongs to limited company not to overall company. The definition lacks to outline of private limited. Lord Justice James (as cited in Paul, 1996) mentions that:

> Company as an association of persons united for a common object. Such an association may be in the form of an ordinary partnership, or a society registered under the Society Registration Act, or a Provident Society, or a Trade Union or Company incorporated by Royal Charter or By an Act of Parliament or by some Indian Law, or it may be a company incorporated under the Act related to companies.

Similarly Haney (as cited in Bagrial, 1992) assets, "company is an incorporated association, which is an artificial person created by law having separate entity, with a perpetual succession and a common seal".

These definitions clearly bring out the characteristics of a company. A company is created by law. It comes into existence only when it is registered under the Company Act.

10.9.1 Features of a Company

The main features of a company are mentioned below:

☐ Incorporated Association
A company is created when it is registered under the Company Act. Moreover, it is considered illegal to operate without registration.

In Nepal, at least seven persons can form a public company where at least one can form a private company. These persons will subscribe their names to the memorandum of association and also comply with other legal requirements of the Act in order to register to form and incorporate a company with or without limited liability.

☐ Artificial Legal Person
A company is an artificial person. It exists in the eyes of law and cannot act on its own. It has to act through a board of directors elected by the shareholders. In many cases a company is a legal person like a natural person. It has the right to acquire and dispose off the property to enter into contract with third parties in its own name, and can sue and be sued in its own name.

☐ Separate Legal Entity
Separate legal entity means that a company has a legal entity distinct from and independent of its shareholders. The company is not in any way liable for the individual debts of its shareholders. Property of the company is to be used for the benefit of the company and not for the personal benefits of the shareholders.

☐ Perpetual Succession
A company has perpetual succession and is independent of the life of its shareholders. Its existence is not affected in any way by the death, insolvency or exit of any shareholders.

☐ Limited Liability
One of the most significant advantages of company is that the liability of its shareholders is limited. In case of a company limited by shares, the liability of shareholders is limited to the extent of the nominal value of shares held by them.

☐ Transferable Shares
In a public company, the shares are freely transferable. The right to transfer shares is a statutory right and it can not be taken away by a provision in the articles.

☐ Common Seal
A company is an artificial person. It cannot act on its own. It acts through natural persons who are known as directors. All contracts entered into by the directors must be under the common seal of the company.

☐ Separate Property

A company, being a legal person, is capable of owning, enjoying and disposing off property in its own name. The property of the company is to be used for the company's business and not for the personal benefit of its shareholders.

☐ Capacity to Sue and Being Sued

The company is a legal person and it can enforce its legal rights. Similarly, it can be sued for breach of its legal duties.

Company Act 1997 of Nepal includes two types of limited companies 惘 private limited company and public limited company.

Private limited company has limited by number of shareholders. It may be incorporated by sole shareholder to 50 shareholders. It does not float its shares into the market for equity capital and it has no right for issuing of debenture from capital market.

Public limited company has not been limited with number of shareholders. It may incorporate more than seven founder shareholders. It can float its share into open markets. The shares of public limited companies are listed on stock exchange for liquidity. In Nepal, all commercial banks other than National Commercial Bank, all finance companies, all insurance companies are examples of limited companies.

10.10 PRIVATE LIMITED COMPANIES

Private limited company is a company which is not permitted to issue share to the public. It contrasts with a limited company, which is permitted to issue share to the public. The Private Limited Company neither issues its share nor debenture to the public. It should limited in number of shareholders too.

CASES AND SOLUTIONS

1. The following is Income Statement of Moonlight Sugar P. Ltd. situated in underdeveloped area.

Particulars	Rs.	Particulars	Rs.
Opening stock of sugar	52,000	Sale of sugar/ molasses	5,058,000
Cane purchased	3,469,000	Closing stock of sugar	76,000
Manufacturing expenses	656,000	Net gain from disposal	
Salaries and wages	225,000	of business assets	10,000

Distribution of profits	46,000	Dividend income	30,000
Donation	88,000	Consultancy income	
Commission & brokerage	36,000	of sugarcane planting to	
Interest on loan	90,000	farmer	25,000
Director's fees	35,000	Interest income	
Auditor's fees	10,000	from credit sales	10,000
R&D costs	54,000	Bad debts recovered	25,000
Bad debts	16,000		
Provision for bad debts	13,000		
Depreciation	164,000		
Net profit	280,000		
	5,234,000		5,234,000

Additional information:

1. Opening stock was overvalued by 10 percent.
2. Salaries and wages include contribution to an unapproved retirement fund Rs. 7,000.
3. Commission and brokerage include account of secret commission disbursed through the managing agents of Rs. 10,000. The company tried to satisfy to assessor in every respect except furnishing names of the payee as such disclosure would be harmful to its business.
4. 25 percent of interest was paid to a merchant without withholding.
5. Distribution of profits includes loan commitment charge to bank Rs. 5,000 and dividend to the shareholders Rs. 41,000.
6. Fifty percent dividend was received from non-resident company.
7. Allowable of depreciation allowance was Rs. 155,000.
8. Forty percent bad debts were not allowed previously.
9. Cane purchased includes cash payment to farmers Rs. 120,000 at once time.

Required:

(a) Assessable income from business

(b) Statement of taxable income

(c) Tax liability [10+3+3]

Solution:

Calculation of profit and gains and assessable income from business of Moonlight Sugar P. Ltd. for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		Amounts	Amounts
1	Service fee	25,000	

2	Income derived from disposal of trading stock	5,058,000	
3	Amounts derived from investments that are effectively connected with business [Int.]	10,000	
4	Net gain from disposal of business assets		
5	Bad debts recovered remitted in earlier income year	10,000 15,000	
Total inclusions		5,118,000	5,118,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	320,000	
2	Interest expenses	90,000	
3	Cost of trading stock [w/n 2]	4,096,273	
4	Depreciation allowances	155,000	
5	R&D costs [w/n 3]	54,000	
Total of deduction		4,715,273	4,715,273
Business income			402,727
DEDUCTIBLE LOSSES			
	Carry forward of unrelieved losses - previous year		-
Assessable income			402,727

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from business	402,727
	Assessable income from investment	15,000
Assessable income		417,727
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt organization	22,836
Taxable income		394,891

CALCULATION OF TAX LIABILITIES

TAXABLE BASE		394,891
1	Taxable income Rs. 394,891@ 16%	63,183
CALCULATION OF ADDITIONAL TAX		
2	1.5% of the taxable income Rs. 394,891	5,923
Tax liabilities		69,106

Working note:

1. General deductions

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Salary and wages	225,000	7,000	218,000
2	Bad debts	29,000	13,000	16,000

3	Loan commitment charge	5,000	-	5,000
4	Commission & brokerage	36,000	-	36,000
5	Director's fee	35,000	-	35,000
6	Auditor's fee	10,000	-	10,000
Total		340,000	20,000	320,000

2. Cost of trading stock

Particulars			Amounts
Opening stock		52,000	47,273
	Less: amount of overvalued	4,727	
Add	Purchase	3,469,000	4,125,000
	Manufacturing expenses	656,000	
Less	Closing stock		76,000
Cost of trading stock			4,096,273

3. Calculation of R&D costs

1	Total of inclusion from business		5,118,000
DEDUCTIONS			
1	General deduction	320,000	
2	Cost of trading stock	4,096,273	
3	Interest deduction	90,000	
4	Depreciation	155,000	4,661,273
Adjusted taxable income			456,727
	50% of the adjusted taxable income		228,363.50
	R&D costs incurred during the year		54,000
Thus, deductible cost of R&D is Rs. 54,000			

Clarification:

1. Cash payment to farmer or primary producer, even paid more than Rs. 50,000 at once chance is deductible amount to the payer/taxpayer.
2. Industries except alcohol and tobacco intensive observe as special industries. The rate of tax for those industries relevant at the rate of 20 percent. Moreover, industries established in underdeveloped area are taxed at the rate of 80 of the rate otherwise applicable.
3. Contribution to unapproved retirement fund is not deductible amount.
4. Dividend received by resident from non-resident company is taxable income from investment.

2. Given below is Income Statement of Sunlight P. Ltd. for the relevant previous year.

Particulars	Amount	Particulars	Amount
Salaries and allowance	725,000	Sales revenue	1,450,000
Rent and taxes	63,000	Net gain on sale of	
Legal expenses	18,000	business assets	18,000
R&I cost	57,000	Interest from lending	
General expenses	34,000	activities	112,000
Reserve for bad debt	15,000	Rent received from	
Donation	44,000	property	40,000
Depreciation	80,000	Gift from business	
Provision - income tax	150,000	clients	10,000
Cost of patent right	56,000	Net gain on sale of	
R&D costs	193,000	depreciable assets	
Net profit	245,000	(vehicle)	50,000
	1,680,000		1,680,000

From the above Income Statement, calculate tax liability of Sunlight P. Ltd. for relevant assessment year after taking into account of the following additional information:

1. Salary and allowance include a lump sum payment made to an employee of Rs. 10,000. However, retirement was forcefully and was not in favor of the company.
2. Rent and taxes include payment of customs of Rs. 4,000 and penalty paid to local government Rs. 5,000. The penalty was paid against violation of local rules.
3. Legal expenses include payment of legal expenses in connection to writ petition for defending title of company's property of Rs. 4,000.
4. Costs of R&D include income tax Rs. 5,000 and purchase for machinery Rs. 20,000.
5. R&I cost includes commission on sale of investment Rs. 1,500 and remaining whole portion of Rs. 55,500 of R&I cost concerns to office equipment.
6. Depreciable base of the office equipment relates with:
   (a) Net balance from previous year Rs. 170,000;
   (b) Additions on Falgun 10, 20xx Rs. 210,000 and
   (c) Disposal of Chaitra 10, 20xx Rs. 70,000 (residual value Rs. 50,000).
7. Interest income was received and rent expense was paid as gross.

8. Bad debts of Rs. 5,000 were not mentioned in the above Income Statement.

Solution:

Calculation of profit and gains and assessable income from business of Sunlight P. Ltd. for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		**Amounts**	**Amounts**
1	Service fee	1,450,000	
2	Amounts derived from investments that are effectively connected with business	112,000	
3	Amount of gift received in respect of business	10,000	
4	Net gain on sale of depreciable assets	50,000	
5	Net gain on sale of business assets	18.000	
Total inclusions		1,640,000	1,640,000
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	831,500	
2	R&I costs [w/n 2]	16,800	
3	Depreciation allowance	80,000	
4	R&D costs [w/n 3]	168,000	
Total of deductions		1,096,300	1,096,300
Business income			543,700
DEDUCTIBLE LOSSES			
	Carry forward of unrelieved losses		-
Assessable income			543,700

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business	543,700
2	Assessable income from investment	40,000
Assessable income		583,700
Deduction from assessable income		
	Donation to exempt organization [5% of Rs. 751,700 (711,700+40,000)]	37,585
Taxable income		546,115

CALCULATION OF TAX LIABILITIES

	TAXABLE BASE	546,115
	Taxable income Rs. 546,115 @ 25%	136,528.75

CALCULATION OF ADDITIONAL TAX

	Taxable income Rs. 546,115 @ 1.5%	8,191.73
Tax liabilities		144,720.48

Working note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Salary and allowances	725,000	10,000	715,000
2	Rent and taxes	63,000	5,000	58,000
3	Bad debts	5,000	-	5,000
3	Legal expenses	18,000	-	18,000
4	General expenses	34,000	-	34,000
5	Commission on sale of investment	1,500	-	1,500
	Total	846,500	15,000	831,500

2. Calculation of R&I costs

Net balance from previous year			170,000
Add:	Absorbed additions [2/3×210,000]	140,000	
Less:	Disposal during the year	(70,000)	70,000
Depreciable base of the equipment			240,000
	Seven percent of the depreciable base		16,800
	R&I cost for the year [Rs. 57,000 - 1,500]		55,500
Thus, deductible cost of R&I is Rs. 16,800.			

3. Calculation of R&D costs

Total inclusions from business			1,640,000
Deductions:			
1	General deductions	831,500	
2	R&I costs	16,800	
3	Depreciation allowances	80,000	928,300
Adjusted taxable income			711,700
50 percent of the adjusted taxable income			355,850
R&D cost incurred during the year [Rs. 193,000- 25,000]			168,000
Thus, deductible cost of R&D is Rs. 168,000.			

Clarification:

1. Cost of patent right is capital cost thus that is not deductible from revenue income.
2. Any reserve or provision — 'reserve' for bad debts or tax; 'provision' for tax or bad debt 惘are not deductible amount.

REVIEW QUESTIONS AND CASES

1. The following is Income Statement of Man Power Supplier Pvt. Ltd Co. for the year ended ……..

Particulars	Amount	Particulars	Amount
Salaries	2,230,000	Commission income	3,705,000
Document delivery	50,000	Net profit sale on shares	15,000
Audit fees	15,000	Dividends from non-	
Legal expenses	10,000	resident Co. without	
R&I cost - furniture	40,000	withholding	35,000
Rescue expenses	90,000		
Dinner, Tiffin and others	70,000		
Reserve for bad debts	10,000		
Depreciation	115,000		
Traveling insurance	8,000		
Postage and stationery	72,000		
R&D costs	875,000		
Net profit	170,000		
	3,755,000		3,755,000

Additional information:
1. Legal expenses include a sum of Rs. 4,000 paid Arabian country to receive document adopting through illegal way.
2. R&I costs of furniture and fixture include spent amount of motivation for supplied manpower of Rs. 10,000.
3. Carry forward of business loss from last two years is Rs. 220,000.

Required:

Tax liability for the relevant assessment year [8]

2. Yellow Bangala Construction (P.) Ltd. presented the following Income Statement for the previous year.

Expenses	Amount	Income	Amount
Opening stock	8,214,000	Sales	16,240,000
Purchase	2,500,000	Advance received	260,000
Construction costs	14,819,000	Closing stock	11,942,000
Gross profit	2,909,000		
	28,442,000		28,442,000
Advertisement	60,050	Gross profit	2,909,000

Audit fee	10,000		
Bank interest	210,500		
Electricity and water	8,500		
Entertainment	11,500		
Miscellaneous	18,000		
Printing & stationary	27,500		
Staff salary	285,600		
Telephone charges	6,500		
Transportation	14,000		
R&I costs	3,860		
Depreciation	73,400		
Net profit	2,179,590		
	2,909,000		2,909,000

Additional information availed in management representation letter:

1. Sales income does not include a value of piece of land which was sold on Baishakha 15, at Rs. 245,000.
2. Construction costs of the Income Statement are based on cash price. In accrual basis obligation to pay construction expense is yet Rs. 450,000.
3. Closing price is overvalued by 2.25 percent.

Required:

(a) Assessable income

(b) Tax liabilities [6+2]

3. Given below is Income Statement of Light Trading (P.) Ltd. for the previous year.

Particulars	Amount	Particulars	Amount
Opening stock	750,000	Income from	
Purchases	8,520,000	overseas export	19,075,000
Freight and insurance	750,000	Rent from upstairs	
Salaries	3,450,000	shutters after	150,500
Director's fee	35,000	withholding	
Audit fee	25,000	Balance transferred	
Legal expenses	50,000	to income statement	
R&I cost - building	1,514,000	from loan A/c	
Commission on export	210,000	(liability foregone	
Printing and stationery	25,000	some creditors)	200,000
Interest	2,250,000	Interest income	200,000
Reserve for taxation	25,000	Closing stock	850,000
Depreciation allowance	1,310,000		

Traveling expenses	130,000		
Proposed bonus	600,000		
Net profit	831,500		
	20,475,500		20,475,500

Representation letter of management of the (P) Ltd. disclosed the following additional information to auditor for the purpose of tax assessment.

1. Legal expenses include:
   (a) Personal legal expenses of the Directors Rs. 5,000
   (b) Expenses related to tax Rs. 10,000
   (c) Legal expenses born in courses of business Rs. 35,000.
2. The entire interest was paid to tax exempt control entity.
3. Allowable depreciation allowance was lower than Rs. 15,000 as compared to debited amount of the Statement.
4. Freight and insurance includes demurrage charge paid to Calcutta port of Rs. 15,000.
5. Director used goods from stock equivalent to Rs. 25,000 that is not deducted from the closing stock.
6. Depreciable base for the building was Rs. 7,500,000 at the end of previous year.

Required:

(a) Assessable income from business
(b) Tax liabilities [12+4]

4. Given below is Income Statement of Real Estate Private Limited Company for the previous year.

Particulars	Amounts	Particulars	Amounts
Opening balance	10,000,000	Sale of land & building	30,020,000
Purchase of land	9,000,000	Rent from old house	625,000
Land registration charge	540,000	Dividend from other	
Manufacturing cost	13,200,000	Companies	125,000
Staff salary	2,400,000	Interest from FD	175,000
R&I cost - old building	289,500	Compensation	350,000
Communication exp.	165,000	Net gain from disposal	
Water and electricity	235,000	of business assets	2,450,000
Depreciation allowance	860,500	Bad debts recovered	2,000,000
Donation - political parties	150,000	Surplus from lottery	435,000
Hospitality expenses	35,000	Closing balance	4,681,500
Interest	260,000		
Transportation expenses	126,000		

Lottery expenses	400,500		
Gift to client	125,000		
Net profit	1,215,000		
	40,861,500		40,861,500

Management's representation letter disclosed the following information:

1. Depreciable base of the old building was Rs. 4,000,000.
2. Bad debts recovered allowed previously was Rs. 1,860,000.
3. Directors of the company have provided one building free of cost to their relatives; its prevailing market price of the rent was Rs. 15,000 per month.
4. Staff salary includes advance salary of manager Rs. 40,000.
5. Manufacturing cost of building includes new land inquiry cost Rs. 40,000 however; it has not been purchased in the previous year.
6. Entire interest was paid to an NGO without withholding.
7. Dividend from other companies includes:
   (a) Dividend from private limited company Rs. 15,000.
   (b) Dividend from Co-operative Society Limited Rs 20,000
   (c) Dividend from non-resident company Rs. 90,000

Required:

(a) Assessable income from business

(b) Tax liability [10+6]

5. The following is the previous year's Income Statement of an X Consultancy Private Limited Company situated in remote area.

Particulars	Amounts	Particulars	Amounts
Consultant's salary	5,000,000	Consultancy income	6,050,000
Allowance and airfare	390,000	Refund of staff salary	22,000
Report reproduction costs	164,000	Interest on adv. salary	38,000
Staff salary	690,000	Sale of computer	150,000
Office rent	72,000	Compensation	
Communication	65,000	from consultant	26,000
Porter charge	135,000	Amount of change	
Packaging expenses	15,000	in accounting system	35,000
Supporting material purchase	90,000	Payment from	
R&I costs of computer	18,000	natural resources	70,000
Traveling insurance premium	17,000	Dividend from Joint	
Printing and stationary	13,000	Venture Company	
Shelter and camping charge	27,000	(X consultancy is the	
Donation to HIV club	45,000	leading company)	703,000
Depreciation allowance	165,000		

Donation to religious entity	6,000		
Worship expenses	4,000		
Picnic expenses	10,000		
Net profit	168,000		
	7,094,000		7,094,000

In management's representation letter, the additional information were:

1. Descriptions of computer were:
   (a) Opening balance Rs. 135,000.
   (b) Absorbed addition during the previous year Rs. 55,000.
2. Allowable depreciation allowance was Rs. 145,000
3. Closing stock of supporting material to trainee was Rs. 35,000.
4. Refund of staff salary was an amount of refund of advance salary.
5. Porter charge includes:
   (a) Yak transportation charge Rs. 15,000
   (b) Baggage charge of helicopter Rs. 48,000
   (c) Individual porter charge Rs. 72,000
6. Allowance and airfare includes compensation paid by the company Rs. 35,000 in the case of breach of a contract which was not in favor of the company's benefit.
7. Shelter and camping charge includes some capital goods a sum of Rs. 6,000.
8. Traveling insurance premium includes business shifting expenses from non-urban to urban Rs. 4,000.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

6. The following is the previous year's Income Statement of Daylight Industry P. Ltd. established in special economic zone for export promotion.

Particulars	Amounts	Particulars	Amounts
Opening stock	600,000	Income from export sales	6,020,000
Purchase	2,100,000	Commission income	210,000
Freight and insurance	130,000	Bad debts recovered	60,000
Wages	650,000	By closing stock	650,000
Salaries	300,000		
Guest and hospitality	50,000		
Donation	400,000		
Depreciation	260,000		
Advertisement	50,000		
Bad debts	30,000		

Provision of bad debts	80,000		
PC costs	650,00		
General expenses	850,000		
Dividend and bonus	80,000		
Net profit	710,000		
	6,940,000		6,940,000

Management representation letter disclosed the following additional information:

1. Closing stock was undervalued by 10 percent.
2. Salary includes construction of additional part of office building Rs. 30,000.
3. Donation was paid to:
   (a) Trade Union Rs. 100,000;
   (b) Pashupati Development Trust (PDT) Rs. 200,000 and
   (c) Kathmandu University Rs. 100,000.
9. Allowable depreciation was Rs. 265,000.
10. Bad debts recovered were Rs. 40,000 remitted earlier.
11. General expenses were:
   (a) Office expenses Rs. 240,000;
   (b) R&D cost Rs. 260,000;
   (c) Purchase of office furniture Rs. 100,000 and
   (d) General office supplies Rs. 250,000.
12. Guest and hospitality includes provision of tax Rs. 15,000.

Required:

(a) Assessable income from business.
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

7. The following is Income Statement of Sun Light Hotel P. Ltd. for the previous year.

Particulars	Amounts	Particulars	Amounts
Opening stock of goods	163,400	Sales:	
Purchase:		(a) Food	2,090,000
(a) Food stuff	961,000	(b) Beverage	2,122,000
(b) Beverage	1050,000	(c) Room charges	1,409,000
(c) Kitchen fuel	68,000	Laundry income	39,000
Wages for kitchen staffs	890,000	Telephone, fax and e-mail	109,500
Tour operating costs	450,000	Net gain from disposal of	
Transportation charges	120,000	business assets	41,000
Laundry and others	40,000	Booking commission:	
Electricity charges	190,000	(a) Air ticket	26,350
Water drilling costs	25,000	(b) Bus ticket	13,125
Salary of office staffs	680,000	Tour operating income	619,000

Printing and stationary	55,000	Closing stock	122,300
Advertisement	160,000		
Guest and hospitality	90,000		
R&I costs:			
(a) Office furniture	6,000		
(b) Office equipment	10,000		
(c) Hotel building	190,000		
R&D costs	140,000		
PC costs	160,000		
Depreciation	250,000		
Promotional expenses	25,000		
Telephone charge	145,000		
Fax and e-mail charge	66,000		
Traveling charge	65,000		
General office expenses	140,000		
Net profit	451,875		
	6,591,275		6,591,275

Management of Hotel disclosed the following information:

1. Closing stock was overvalued by Rs. 10,200.
2. Kitchen fuel includes manager's resident fuel of Rs. 4,500.
3. Water drilling cost relates capital cost of the hotel.
4. Promotional expense relates to hoarding board of the hotel.
5. 50 percent of advertisement expense was paid on cash at once chance.
6. General expense includes cost of sofa set used in lobby Rs. 25,000.
7. Unrecorded income from room charges was Rs. 9,200.
8. Electricity charge includes purchase of room heater Rs. 16,000.

Required:

(a) Assessable income from business.
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

8. Hira Brick Factory (P.) Ltd. presented the following Income Statement for the previous year.

Particulars	Amounts	Particulars	Amounts
Opening balance	850,000	Kiln brick sales	6,590,000
Soil purchase	915,000	Green brick sales	235,000
Cost for digging	372,000	Sale of old newspaper	1,260
Costs of cement	12,500	Net gain from disposal of business assets	48,800
Coal and wood costs	1,035,000		
Sand costs	204,000	Closing balance	702,000
Labor wages	2,235,000		
Salary	375,000		

Communication	26,900		
Green brick damage	118,360		
R&I costs of tools	10,100		
R&I costs of chimney	30,500		
PC costs	715,000		
Entertainment	15,000		
Guest and hospitality	11,200		
Donation	17,500		
Commission to agent	15,000		
Depreciation	235,000		
Printing and stationery	13,000		
Miscellaneous expenses	76,000		
Net profit	295,000		
	7,254,700		7,577,060

Factory management disclosed the following information:

1. Kiln bricks having costs of Rs. 150,000, used by the company directors were not shown in the above statement. The prevailing market price of the used bricks was Rs. 183,250.
2. Closing stock includes kiln bricks (blacked) which were neither salable nor useable for other purposes Rs. 35,000.
3. PC cost includes purchase of air conditioner for using in manager's office of Rs 35,000.
4. Depreciable base value were:
   (a) Tools Rs. 290,000
   (b) Chimney Rs. 390,000
5. In accrual basis of accounting method, amount of compensation equivalent to damage brick is receivable however; the company has not made any entry for this transaction in the previous year.
6. Labor wages includes installation charges of computer Rs. 2,200.

Required:

(a) Assessable income from business.
(b) Statement of taxable income
(c) Tax liabilities [10+2+4]

9. Poly Tank Industry P. Ltd. stated the following Income Statement for the previous year.

Particulars	Amounts	Particulars	Amounts
Opening stock	2,325,000	Sale of poly tank	19,000,000
Purchase of raw materials	5,300,000	Sale of scrap	130,000
Custom duty	435,000		
Wages	3,653,000		

Freight and insurance	360,000		
Normal wastage	140,000		
Water and electricity	260,000		
Gross profit	6,657,000		
	19,130,000		19,130,000
Salary	1,013,000	Gross profit	6,657,000
Contribution to RF	90,500	Rent from staff quarter	380,000
General office charges	156,000	Interest income	680,000
Telephone and fax	63,000	Interest from credit sales	36,000
Entertainment expenses	18,000		
Printing and stationary	28,500		
Depreciation	397,000		
Donation	180,000		
Interest	1,125,000		
Membership fee	15,000		
Traveling expenses	150,000		
Conveyance expenses	24,000		
R&D costs	650,000		
PC costs	290,000		
R&I costs	53,600		
Staff Tiffin	86,200		
Bonus	193,000		
Staff gratuity	43,500		
Laboratory test expenses	19,200		
Net profit	3,157,500		
	7,753,000		7,753,000

Management report disclosed the following information:

1. The industry is controlled by tax exempt entity.
2. Interest consists:
   (a) Rs. 70,000 paid to a bank,
   (b) Rs. 75,000 paid to a domestic money lender without deducting tax deduction at source and
   (c) Rs. 980,000 paid to tax exempt control entity (parent entity).
3. Traveling expenses includes personal expenses of managing director Rs. 25,000.
4. Donation relates:
   (a) Two-fifth portion of donation was paid to a political party which was not registered in Election Commission and
   (b) Three-fifth portion was paid equally to Pashupati Development Trust (PDT) and Boxing Club of Kathmandu.
5. Salary includes compensation paid to a staff against firing of Rs. 15,000 however; it was on the favor of company.
6. General office charge includes:

(a) Rs. 10,000 lawyer charge to sue to defend tax case.
(b) Rs. 25,000 lawyer charge to defend the title of assets.
(c) Rs. 35,000 was expenses of Tiffin, pamphlet, and announcing on the occasion of road demonstration of the businessmen.
(d) Remaining portion was general office expenses.

7. Freight and insurance includes double payment to a party Rs. 45,000, which is irrecoverable forever.

Required:

(a) Assessable income from business.
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

10. Hamlet Light Hydropower P. Ltd. produces and distributes hydro-electricity in remote area. It has presented the following Income Statement for the previous year.

Particulars	Amounts	Particulars	Amounts
Production expenses	3,300,000	Sale of electricity	30,600,000
R&I cost of power line	930,100	Fine and penalty	90,500
Plant operators salary	2,250,000	Rent from staff quarter	40,000
Salary	1,514,000	Interest income	110,000
Contribution to RF	109,500		
General office charges	16,000		
Telephone and fax	163,000		
Printing and stationary	48,100		
Depreciation	4,325,000		
Donation	460,000		
Interest	5,325,000		
Traveling expenses	35,000		
Conveyance expenses	44,000		
R&D costs	700,000		
PC costs	490,000		
R&I costs	250,900		
Rent of line tower	255,000		
Payment of tax on rent	45,000		
Staff gratuity	150,000		
Staff medical charge	43,000		
Staff uniform charge	65,000		
Net profit before bonus	10,321,900		
	30,840,500		30,840,500

Management representative letter includes the following information:

1. Salary includes directors fees Rs. 160,000.
2. Interest includes:
   (a) Rs. 25,000 fine of delay payment of interest to bank.
   (b) Rs. 55,000 loan commitment charge.
   (c) Rs. 5,245,000 interest of loan.
3. Traveling expenses includes personal expenses of managing director Rs. 25,000.
4. Donation includes construction cost of a building in local area as contribution by the company.
5. Company has decided to distribute the bonus as per prevailing law however; it is not made provision in the above Income Statement.
6. Local municipality has not paid road light charge Rs. 165,000 of the previous year and it is also not accounting as accrual basis.
7. A debt of Rs. 250,000 was bankrupt in the previous year however it is not written off.

Required:

(a) Assessable income from business.
(b) Statement of taxable income
(c) Tax liabilities [10+4+2]

11. The following is Income Statement of Red Poultry Farming Company (P) Ltd. You are required to compute tax liability for the previous year.

Expenses	Amount	Income	Amount
Cost of goods sold	1,325,000	Sales:	
R&I cost of building	125,000	(a) Chicken sales	2,525,000
Donation expenses	25,000	(b) Egg sales	275,000
Printing and stationary	20,000	Net gain disposal	
Postal charge	15,000	of business assets	250,000
Telephone and fax	135,000	Income form	
Staff salary	855,000	accepting a	
Compensation amount	45,000	restriction in	
R&D cost	50,000	respect of business	350,000
PC cost	20,000		
Provision of tax	150,000		
Staff's uniform expenses	250,000		
General office expenses	175,000		
Net Profit	210,000		
	3,400,000		3,400,000

Representation letter of management disclosed the following additional information:-

1. Salary includes ex-employee's salary of Rs. 35,000.
2. Cost of goods sold was calculated ignoring the vary balance of opening and closing stock. According to accounting record opening stock was undervalued by 10 percent while closing stock was overvalued by 10 percent. The balance of opening stock and closing stock were Rs. 150,000 and Rs. 200,000 respectively.
3. Income from restriction was recorded on the basis of period method. On the basis of period it was 50 percent.
4. 50% amount of the compensation was paid to the worker who is firing forcefully. It was against the favor of the company.
5. PC cost includes R&I cost of air conditioner of Rs. 2,000. The depreciation value of the depreciable assets (air conditioner) was Rs. 50,000.
6. The income statement was not fairly presented. The company was let out two rooms at the rate of Rs. 5,000 per month to another person which was not shown in the above Income Statement.

Required:

(a) Assessable income

(b) Tax liabilities [12+4]

12. Fishling Concrete Industry P. Ltd., Fishling of Prithivi Highway presented the following Income Statement for the previous year.

Expenses	Amount	Income	Amount
Purchase of stone	2,450,000	**Sales:**	
Collection of stone	250,000	(a) Concrete	4,850,000
Stone collector wages	15,500	(b) Stone powder	850,000
Cost of electricity	240,000	**Stocks:**	
Crossing cost of stone	650,000	Stock of concrete	1,050,000
Staffs salary	350,000	Stock of stone	450,000
Printing and stationery	15,000		
Donation	25,000		
PC cost	150,000		
R&D cost	550,000		
Communication	35,000		
Traveling	55,000		
R&I cost of machine	58,000		
Miscellaneous	25,000		
Guest and hospitality	30,000		
Worship expenses	55,000		
Staff medical expense	15,000		
Net profit	2,231,500		
	7,200,000		7,200,000

According to letter of management the following information were disclosed:

1. The stated income statement is based on cash bases method. According to income tax Act, the company needs to follow the method of accrual. As to accrual it relates the following facts:
   (a) Disposal of concrete on credit Rs. 250,000
   (b) Purchase of stone on credit Rs. 300,000
   (c) Payable salary Rs. 25,000
   (d) Refundable amount from traveling Rs. 10,000
3. The statement does not disclose the balance of opening stocks. They were:
   (a) Stock of concrete Rs. 895,000
   (b) Stock of stone Rs. 490,000
4. Allowable depreciation for the year was Rs. 135,000.

Required:

(a) Assessable income

(b) Tax liabilities [12+4]

13. The following is Income Statement of Mustang Flowari Culture Trading Co. (P.) Ltd. for the previous year. Calculate assessable income and tax liability for the relevant year.

Expenses	Amount	Income	Amount
Opening stock:		**Sales:**	
(a) Flower	190,000	(a) Flower	2,650,000
(b) Plants	290,000	(b) Plants	450,000
(c) Seeds	270,000	(c) Seeds	250,000
Purchase:		**Closing stock:**	
(a) Flower	190,000	(a) Flower	290,000
(b) Plants	1,150,000	(b) Plants	390,000
(c) Seeds	221,000	(c) Seeds	370,000
Custom and duty	275,000		
Municipality fee	25,000		
Wages	425,000		
Gross profit	1,364,000		
	4,400,000		4,400,000
Entertainment	15,000	Gross profit c/d	1,364,000
Donation to club	15,000	Bonus on sales	
PC costs	175,000	received after	
R&D costs	200,000	withholding in India	140,000
Communication	29,000	Best seller prize	25,000
Medical treatment	11,000		
Staff salary	295,000		

R&I cost	25,000		
Depreciation	75,000		
Miscellaneous	75,000		
Depreciation	114,000		
Net Profit	500,000		
	1,529,000		1,529,000

The management of the company disclosed the following particulars:

1. Opening stock was overvalued by 5 percent.
2. Closing stock includes damaged of the following:
   (a) Seeds Rs. 5,000
   (b) Plant Rs. 15,000 and
   (c) Flowers Rs. 18,000
3. Miscellaneous expenses include:
   (a) Auditor's remuneration for financial audit Rs. 5,000
   (b) Auditor's remuneration for tax audit Rs. 7,000
   (c) Audit related expenses Rs. 4,000
   (d) Pesticide for the plants Rs.15,000
   (e) Manure for plants Rs. 25,000
   (f) Delivery charge of the plants, seeds, and flower Rs. 19,000.
4. Staff salary includes gratuity of Rs. 25000.
5. R&D costs include establishment and shifting expenses of the company from undeveloped to the developed area.
6. Purchase includes plastic cost of Rs. 17,000 to protect plants from heavy rain and strong light.

14. The following is Income Statement of Khadka Books Publishers and Distributors (P.) Ltd. for the previous year. Calculate assessable income and tax liability for the relevant year.

Expenses	Amount	Income	Amount
Opening stock	625,000	Sales of books	9,050,000
Purchase of books	4,805,000	Disposal of damaged	
Cost of publishing	3,200,000	books per kilo Rs. 3	24,000
Book designing	125,000	Closing stock	1,350,000
Cover page designing	135,000		
Commission	60,000		
Custom and duty	290,000		

Loading & unloading	60,000		
Gross profit	1,124,000		
	10,424,000		10,424,000
Membership free	25,000	Gross profit c/d	1,124,000
Printing & stationery	28,000	Rent income	450,000
Miscellaneous	20,000	Interest from deposit	47,000
Communication	40,000	Interest (credit sales)	26,000
Donation	20,000		
Staff salary	450,000		
R&I costs	75,000		
Depreciation	125,000		
PC cost	105,000		
R&D costs	75,000		
Net Profit	684,000		
	1,647,000		1,647,000

Management representation letter disclosed the following additional information:

1. Values of damaged books which are sold in the year in Rs. 24, 000 were not mentioned in opening balance. The cost price of those books was Rs. 96,000. In closing balance it is reduced only by Rs. 24,000.
2. Books were purchased on credit. There is due of Rs. 185,000 till the end of the year.
3. Commission amount was paid without withholding tax.
4. Custom and duty were refunded of Rs. 25,000 but this is not treated in the above statement.
5. Communication expenses include delay payment of fine Rs. 3,500.
6. Cost of publishing includes royalty expenses of writer Rs. 50,000.
7. Interest from deposit was received from bank deposit.

10.11 LIMITED COMPANIES AND CORPORATIONS

A Limited Company is a public company which, by registering as a limited and adhering to strict legal requirements as a result, has the ability to issue shares to the public. Contrast this with a Private Limited Company, which is not permitted to issue shares to the public. The most of public limited company issue their share to the public and its shares should list in stock exchange to keep share in liquid positions. Nepal Stock Exchange Limited lists all the shares in Nepal after fulfilling requirement to be listed.

CASES AND SOLUTIONS

1. The following are the details of the transactions of an Industrial Limited Company for the relevant income year.

Particulars	Amount	Particulars	Amount
Opening stock	700,000	Sales	13,500,000
Purchase	5,300,000	Sales of scraps	25,000
Freight	145,000	Commission	50,000
Wages	2,500,000	Dividends	60,000
Royalty	500,000	Rent from property	300,000
R&I costs	100,000	Profit on sale of land	500,000
Salaries	300,000	Interest	75,000
General charges	600,000	Bad debts recovered	65,000
Legal expenses	80,000	Closing stock	500,000
Provision for tax	50,000		
R&D costs	150,000		
Bad debts	200,000		
Depreciation	700,000		
Entertainment	160,000		
Dividends	80,000		
Advertisement	250,000		
Donations	400,000		
Reserve for bad debts	150,000		
Net profit	2,510,000		
	15,075,000		15,075,000

Additional information:

1. Bad debts recovered of Rs. 4,000 were not allowed previously.
2. Donations were given to:

(a) A public hospital Rs. 110,000
(b) Human Rights (watch) Rs. 90,000
(c) A Boxing Club Rs. 50,000
(d) Maoist Victims Organization Rs. 50,000
(e) Government Victims Organization Rs. 50,000
(f) Mountaineering Rescue Association Rs. 50,000.

3. Legal expenses include amount paid to lawyer for briefing income tax rules to the finance director of Rs. 15,000.
4. Allowable depreciation for the previous year was Rs. 650,000.
5. Purchase includes cost of new computer of Rs. 150,000.
6. General charges include PC cost of Rs. 80,000 and income tax appeal Rs. 25,000.
7. The stated Income Statement does not mention the following amounts:
   (a) Income tax Rs. 60,000 and
   (b) Custom duties Rs. 200,000

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities. [10+4+2]

Solution:

Calculation of profit and gains and assessable income from business of an Industrial Limited Company for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS				
INCLUSIONS			**Amounts**	**Amounts**
1	Service fee		50,000	
2	Amount derived from disposal of trading stock		13,500,000	
3	Amounts derived from investments that are effectively connected with the business:		375,000	
	(a) Rent from property	300,000		
	(b) Interest income	75,000		
4	Amount derived from bad debts remitted earlier income year		61,000	
5	Net gain from disposal of business Assets of the person		500,000	
6	Other received or receivable amount as per the Act (sales of scraps)		25,000	
Total inclusions			14,511,000	14,511,000

DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	1,985,000	
2	Cost of trading stock [w/n 2]	8,195,000	
3	R&I costs	100,000	
4	Depreciation allowances	650,000	
5	R&D costs [w/n 3]	150,000	
6	PC costs	80,000	
Total of deduction		11,160,000	11,160,000
Business income			3,351,000
DEDUCTIBLE LOSSES			
	Carry forward of unrelieved losses		-
Assessable income			3,351,000

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from business	3,351,000
Assessable income		3,351,000
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt organization	100,000
Taxable income		3,251,000

CALCULATION OF TAX LIABILITIES

TAXABLE BASE		3,251,000
1	Taxable income Rs. 3,251,000 @ 20%	650,200

CALCULATION OF ADDITIONAL TAX

2	1.5% of the taxable income Rs. 3,251,000	48,765
Tax liabilities		698,965

Working note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Royalty	500,000		500,000
2	Salaries	300,000		300,000
3	General charges	600,000	105,000	495,000
4	Legal expenses	80,000		80,000
5	Bad debts	200,000		200,000
6	Entertainment	160,000		160,000
7	Advertisement	250,000		250,000
Total		2,090,000	105,000	1,985,000

2. Cost of trading stock

Cost of trading stock				Amounts
Opening stock				700,000
Add	Purchase	5,300,000	5,150,00	7,995,000
	Less: Capital purchase	(150,000)		
	Customs		200,000	
	Freight		145,000	
	Wages		2,500,000	
Less	Closing stock			500,000
Cost of trading stock				8,195,000

3. Calculation of R&D costs

1	Total of inclusion from business		14,511,000
DEDUCTIONS:			
1	General deduction	1,985,000	
2	Cost of trading stock	8,195,000	
2	Repair and improvement	100,000	
3	Depreciations	650,000	10,930,000
Adjustable taxable income			3,581,000
	50% of the adjusted taxable income		1,790,500
	R&D costs incurred during the year		150,000
	PC costs incurred during the year		80,000
Thus, debited costs of R&D and PC are deductible			

Clarification:

1. Dividend income is taken into account as received from resident company in implied case.
2. Dividends are business expenses. These are distribution from entity thus these are deducted from income.
3. Industries other than alcohol and tobacco derivatives are treated as special industries. The tax rates for those industries are applied at the rate of 20 percent.

2. The following is Income Statement of Silver Ltd. established under the Company Act 2053. The management is effectively controlled by Nepal Multipurpose Co-operative Ltd due to it holds 40 percent of its share during the previous year.

Expenses	Amounts	Revenue	Amounts
Opening stock	500,000	Sales	9,975,000
Purchase	5,175,000	Interest income	200,000
Freight & insurance	325,000	Bad debts recovered	100,000

Interest	2,140,000	Net gain from disposal of business assets	100,000
R&I costs	110,000	Compensation amount	200,000
R&D cost	435,000	Rent from staff quarter	55,000
PC cost	300,000	Miscellaneous income	255,000
Donation	120,000	Closing stock	905,000
Depreciation allowance	352,000		
Office supplies	138,000		
Communication exp.	180,000		
Auditor's fee	40,000		
Staff salary	650,000		
Advertisement expenses	23,000		
Net profit	1,302,000		
	11,790,000		11,790,000

Management representation letter disclosed the following additional information:

1. Sales include commission income received from other company Rs. 500,000.
2. Fifty percent interest incomes were received from staff loan. The loan was given at the rate of five percent but in the prevailing market practice such type of loan was at the rate of seven and half percent.
3. Sixty percent bad debts recovered were allowed previously.
4. Miscellaneous income includes the following.
   (a) Sale of newspapers Rs. 12,500
   (b) Dividend income from other listed company Rs. 142,500
   (c) Amount refunded from freight and insurance Rs. 20,000
   (d) Discount from purchase of trading stock Rs. 25,000
   (e) Gift income (received in course of business) Rs. 55,000
5. Freight and insurance includes demurrage amount of Rs. 25,000.
6. Staff salary includes:
   (a) Advance salary Rs. 15,000 and
   (b) Ex-manager salary Rs. 35,000
7. Fifty percent auditor's fee belongs to tax auditing fee and it was paid without withholding tax.
8. Communication expenses were paid to Nepal Telecom Limited (NTC). Among the amount Rs. 65,000 was cash payment at one time which includes Rs. 15,000 as fine for delay payment.
9. Opening stock was overvalued by 15 percent while closing stock was undervalued by 5 percent.

10. The company has made the following transactions from Nepal Multipurpose Co-operative Limited.
    (a) Purchase of trading stock Rs. 500,000 was made ignoring arms length concept. It could be available in Rs. 475,000 if purchased from other persons of the prevailing market.
    (b) Disposal of trading stock Rs. 500,000 was also made ignoring arms length concept. It was saleable in Rs. 525,000 if sold to third party.
11. 75 percent interests were paid to a bank and rest of interest to money lender without withholding.
12. Depreciation allowance was debited without calculation. The Ltd claims as per rule for deduction. The details of the assets were as:

Pool	Opening balance	Additions during the year		Disposal in the year
B	620,000	Bhadra, 15	450,000	-
C	950,000	Magh, 30	450,000	150,000
D	190,000	Ashadh, 09	210,000	-
The actual residual value of the disposed assets was Rs. 50,000.				

13. Donation includes a gift given to a Credit Co-operative (non community based and non-prescribed area) Rs. 12,000 and National Youth Football Club (an exempt entity) Rs. 108,000.
14. R&I cost concerns:
    (a) Pool 'B' Rs. 50,000,
    (b) Pool 'C' Rs. 50,000 and
    (c) Pool 'D' Rs. 10,000.

Required:

(d) With full disclosure of depreciation table. [4]
(e) Assessable income from business
(f) Statement of taxable income and
(g) Tax liabilities [10+3+3]

Solution:

Calculation of profits and gains and assessable income from business of Silver Limited for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		**Amount**	**Amount**
1	Service fee	500,000	
2	Income derived from disposal of trading stock [w/n-1]	9,500,000	
3	Income derived from investment which is directly related to business [w/n-2]	255,000	

4	Net gain from disposal of business assets	100,000	
5	Bad debts recovered which was remitted in earlier income year(earlier income year remitted was only 60%)	60,000	
6	Amount received as compensation	200,000	
7	Gift received in relation to business	55,000	
8	Difference of actual interest and interest as per market rate in case of a soft loan	50,000	
9	Other inclusions [w/n.3]	57,500	
Total inclusions		10,777,500	10,777,500
DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 4]	1,001,000	
2	R&I costs [w/n 6]	110,000	
3	Depreciation allowance [w/n 5]	526,500	
4	Cost of trading stock [w/n 7]	4,932,151	
5	Interest [w/n 8]	2,140,000	
6	PC cost [w/n 8]	300,000	
7	R&D cost [w/n 8]	435,000	
Total of deductions		9,444,651	9,444,651
Business income			1,332,849
DEDUCTIBLE LOSSES			
	Deduction of losses		-
Assessable income			1,332,849

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from business	1,332,849
Assessable income		1,332,849
DEDUCTION FROM ASSESSABLE INCOME		
	Donation [5% deductions]	100,000
Taxable income		1,232,849

CALCULATION OF TAX LIABILITIES

1	Taxable income Rs. 1,232,849@ 25%	308,212.25

CALCULATION OF ADDITIONAL TAX

2	1.5% of taxable income Rs. 1,232,849	18,492.74
Tax liability		326,704.99

Working note:

1. **Amount derived from disposal of trading stock**

Sales amount			9,975,000
Add:	Income as derived from disposal of trading stock according to arms length concept transaction made with Nepal Multipurpose Co-operative Limited	25,000	
Less:	Commission received by other company included in disposal of trading stock	(500,000)	(475,000)
Income derived from disposal of trading stock			9,500,000

2. **Income derived from investment that is directly related to business.**

1	Interest income	200,000
2	Rent from parking stall	55,000
Income derived from investment		255,000

3. Other inclusions in miscellaneous income

1	Sale of newspapers	12,500
2	Discount received from purchase of trading stock	25,000
3	Amount received from refunded freight & insurance	20,000
Total of other inclusions in profit and gains		57,500

4. General deductions

Office supplies		138,000
Communication expenses	180,000	
Less: Fine for delay payment	(15,000)	165,000
Auditor's fee		40,000
Advertisement expenses		23,000
Staff salary	650,000	
Less: Advance salary	(15,000)	635,000
Total of general deduction		1,001,000

5. Depreciation allowance

Pool	**B**	**C**	**D**	**Total**
Opening balance	620,000	950,000	190,000	1,760,000
Absorbed additions	450,000	300,000	70,000	820,000
Disposal during the year	-	(150,000)	-	(150,000)
Depreciable base	1,070,000	1,100,000	260,000	2,430,000
Depreciable rate	25%	20%	15%	
Depreciation allowance	267,500	220,000	39,000	526,500
Depreciated value	802,500	880,000	221,000	1,903,500
Unabsorbed additions	-	150,000	140,000	290,000

Capitalized R&I costs	-	-	-	-
Capitalized PC cost	-	-	-	-
Capitalized R&D cost	-	-	-	-
Net value for next year	802,500	1,030,000	361,000	2,193,500

6. R&I costs

Group or pool of assets	B	C	D
Depreciable base	1,070,000	1,100,000	260,000
7% of the depreciable base	74,900	77,000	18,200
R&I costs (actual)	50,000	50,000	10,000
Thus, R&I costs (actual) are deductible amounts for the income year.			

7. Cost of trading stock

Opening stock			500,000	
	Less: Amount of overvalued		(65,217)	434,783
Add:	Purchase	5,175,000		5,450,000
	Less: Excess payment according to arms length	25,000	5,150,000	
	Freight and insurance	325,000		
	Less: demurrage charge (fine)	25,000	300,000	
Less:	Closing stock		905,000	
	Add: amount of undervalued		47,632	(952,632)
Cost of trading stock				4,932,151

8. Calculation of Adjusted taxable income

Total of inclusions			10,777,500
1	General deduction	1,001,000	
2	Interest	2,140,000	
3	Cost of trading stock	4,932,151	
4	R&I costs	110,000	
5	Depreciation allowance	526,500	8,709,651
Adjusted taxable income [for R&D, PC and interest paid to tax exempt controlled entity]			2,067,849
50% of the taxable income			1,033,924.5
DEBITED AMOUNTS			
1	Interest		-
2	R&D costs		435,000
3	PC costs		300,000
Thus, debited figures of R&D and PC are deductible costs.			

REVIEW QUESTIONS AND CASES

1. Given below is the 'income statement' of Neptune Air Ltd. for the previous year.

Particulars	Amount	Particulars	Amount
Flying operation exp.	344,400,000	Passenger income	432,200,000
R&I cost	11,100,000	Cargo income	33,500,000
Passenger service exp.	70,300,000	Excess baggage	2,032,000
Staff salary	13,500,000	Other income	2,707,000
Traveling	3,500,000		
Communication	420,000		
Printing and stationery	160,000		
Insurance charge	650,000		
Business service fee	180,000		
Training expenses	179,000		
Loss on sale of assets	200,000		
Security expenses	170,000		
Staff gratuity	90,000		
Advertisement	350,000		
Interest expenses	16,000,000		
Right share issuing exp.	3,500,000		
Water and electricity	240,000		
Net profit	5,500,000		
	470,439,000		427,732,000

Management of the Ltd. disclosed the following particulars:

1. Depreciable base of airplanes was Rs. 150,000,000.
2. R&I cost includes completion and inspection of test flight of Rs. 3,500,000.
3. Staff salary includes compensation paid to loader Rs. 35,000 who was fired by management without reasonable cause.
4. Insurance charge includes:
   (a) Previous year's due Rs. 150,000 and
   (b) Advance salary to a pilot Rs. 50,000.
5. Advertisement include advertisement expenses of a football club (a tax exempt entity) Rs. 60,000. However, name of the company was clearly exhibited at the end of advertisement.
6. Other income concerns:
   (a) Dividend income from other company Rs. 460,000
   (b) Debenture interest of listed company Rs. 102,000 (net). However, it was not a grossing up figure.
   (c) Sundry receipt Rs. 2,145,000.

7. Flying operation includes:
   (a) Cost of black box Rs. 1,350,000 and
   (b) Donation amount paid to Football Club Rs. 60,000.

Required:
   (a) Assessable income from business
   (b) Statement of taxable income
   (c) Tax liabilities [10+4+2]

2. Following is Income Statement (in million) of a Rubber Industry Limited situated in undeveloped zone. It has provided employment service to 700 Nepalese Citizens throughout the year.

Income Statement for the income year.......

Particulars		Rs	Particulars		Rs.
Opening balance		272	Sales income		3,984
(1) Semi-finished	122		Other income		70
(2) Finished	150		Closing balance		
Purchase of direct raw materials		1,620	(1) Semi-finished	134	
Purchase of indirect raw material		220	(2) Finished	268	402
Purchase of packing material		90			
Manufacturing expenses		1,320			
Traveling		12			
Printing and stationery		14			
Utilities		120			
Auditing including tax audit		5			
Communication		25			
Training		14			
Sales bonus and volume disc.		13			
Prize scheme		8			
Sales promotion		26			
Staff salary		220			
Depreciation		460			
Donation		5			
Net profit		12			
		4,456			4,456

Management disclosed the following additional information:

1. Company has unrelieved loss from previous year Rs. 0.70 million.
2. Opening balance of semi-finished was overvalued by 10 percent but closing balance of finished was undervalued by 5 percent.
3. Value of packing materials of Rs. 10 million was not mentioned in closing balance.

4. Sales promotion includes: compensation paid to agent Rs. 0.80 million; appeal charge related to tax Rs. 0.50 million.
5. Communication includes fine and penalty paid to local government Rs. 3 million.
6. Utilities include: water and electricity charge Rs. 50 million; and purchase of new technology Rs. 70 million.
7. Other income includes: compensation received from agent Rs. 20 million and income from use of logo by others Rs. 50 million.

Required:

(a) Business income
(b) Assessable income
(c) Statement of taxable income
(d) Tax liabilities [8+4+2+2]

3. The following is Income Statement of Nepal Tunnel Company Limited for the previous year. It builds tunnel and handovers to the government. It is engaged to build tunnel throughout the previous year.

Income Statement for the income year .... (Rs. in million)

Particulars	Amount	Particulars	Amount
Opening balance	400	Income from construction	21,596
Purchase of direct material	13,090	Interest income	266
Purchase of indirect material	2,080	Dividend income	950
Construction costs	4,680	Prize received	219
Salary	225	Closing balance	1,255
General expenses	388		
Depreciation allowance	1,156		
Interest expenses	96		
R&I costs	168		
PC costs	868		
R&D costs	465		
Net profit	670		
	24,286		24,286

Management of the limited produced following additional information:

1. General expenses concerns:
   (a) Utilities Rs. 50
   (b) Transportation Rs. 46
   (c) Printing and stationery Rs. 9
   (d) Promotional expenses Rs.16
   (e) Advertisement expenses Rs. 20

(f) Provision for income tax Rs. 122
(g) Site allowance Rs. 23
(h) Establishment expenses Rs. 24
(i) Business shifting expenses Rs. 30
(j) Compensation paid to employee against firing by management Rs. 8. It was decided by labor court with 100 percent penalty.
(k) Provision for future loss Rs 40

2. R&I cost entirely related to Bulldozer. Depreciable base of the Bulldozer was Rs. 2,200 million.
3. Interest income was received from 5 percent loan provided to employees. But, the prevailing market rate for such type of loan was 12 percent.
4. Dividend income was received from non-resident company.
5. Closing balance was overstated by Rs. 20 million.

Required:

(a) Assessable income
(b) Tax liabilities [12+4]

4. The following is Income Statement of Trolley Bus Limited (a listed company in Nepal Stock Exchange) for the previous year. Ascertain tax liability of the company for the relevant income year. [16]

Particulars	Amount	Particulars	Amount
Electricity charge	2,600,000	Public transportation	
Driver & conductor wages	1,960,000	service income	8,680,000
Passenger ticket costs	50,000	Refund of income	
Salaries and wages	230,000	tax funded in earlier	
General expenses	270,000	income year	85,000
Welfare expenses	16,000	Amount derived from	
Family planning		minibus operation	
promotion	20,000	Committee for stopping	
Fines and penalties	160,000	of operation to Route 20	860,000
R&I cost	120,000	Grant received from the	
Income tax paid	160,000	Japanese Govt. as	
Depreciation allowance	920,000	reward for pollution	
Legal expenses	60,000	control scheme run by	
Loss on sale of debenture	80,000	trolleybus	200,000
R&D costs	1,780,000		
General reserve	80,000		
Net profit	1,319,000		
	9,825,000		9,825,000

Management representation letter of the limited disclosed the following additional information:

1. Electricity charge includes penalty for delay payment Rs. 16,000.
2. Passenger tickets were printed 2,500,000 pieces. At the end of year there were 500,000 pieces of passenger ticket in store.
3. General expenses include payment of commission to purchase machinery of trolley bus Rs. 20,000.
4. Legal expenses include lawyer charge to defend income tax by appeal Rs. 6,000.

5. Pashupati Sugar Factory Ltd presented the following Income Statement for the previous year.

Particulars	Amount	Particulars	Amount
Opening balance	1,550,000	Sales of sugar	12,860,000
Cane purchase	7,444,000	Sales of molasses	2,610,000
Manufacturing exp.	2,690,000	Sales of spirit	2,018,000
Freight & insurance	30,000	Interest from farmer	115,000
Salaries and wages	2,150,000	Other receipt	122,000
Legal expenses	40,000	Dividend from agro-	
R&I cost - machinery	1,033,800	based co-operative Ltd.	431,800
General charges	1,620,000	Gain from disposal	
Interest of overdraft	160,000	of liabilities	120,000
Loan commitment charge	40,000	Bad debts recovered	244,200
Depreciation	4,021,000	Closing balance	1,810,000
Entertainment	200,000	Loss of the year	1,007,800
Income tax provision	360,000		
	21,338,800		17,631,000

The Limited is situated in remote area and listed in Nepal Stock Exchange. Management of the limited disclosed the following information:

1. Salaries and wages include compensation amount of ex-worker of Rs. 232,000. The worker was illegally fired.
2. Legal expenses include lawyer charge of Rs. 10,500 for discussion made with finance director about tax rules.
3. Machinery concerns:
   (a) Opening value of the machinery at starting of the income year Rs. 4,000,000,

(b) Purchases made for the previous year were: at Bhadra Rs. 350,000; at Falgun Rs. 450,000 and at Ashadh Rs. 150,000.
(c) Disposal during the previous year was Rs. 550,000. The depreciated value of old machine was only Rs. 150,000.

4. General charges consists the following amounts:
   (a) Donation to Lions Club of Kathmandu Rs. 112,000. It was paid in cash at once chance.
   (b) Printing and stationery expenses Rs. 130,000.
   (c) Personal expenses of the GM Rs. 130,000.
   (d) Water and electricity charge Rs. 390,000. It was also paid in cash including fine Rs. 30,000.
   (e) Transportation cost of sugar cane Rs. 858,000
5. A lot of cane purchase was made from cash payment of Rs. 550,000. The recipient was farmer of the cane.
6. Machinery having depreciable value of Rs. 1,410,000 was depreciated by 30 percent. The excess depreciation allowance has not been adjusted in the above statement.
7. Opening balance of the stock was overvalued by Rs. 50,000 while closing stock was undervalued by 10 percent.

Required:
(a) Assessable income
(b) Statement of taxable income
(c) Tax liability [10+4+2]

6. The following are the details of the transaction of an industrial Company for the relevant fiscal year.

Income Statement

Particulars	Amount	Particulars	Amount
To opening stock	700,000	By sales	13,500,000
To purchase	5,300,000	By sale of scraps	25,000
To freight	345,000	By commission	50,000
To wages	2,500,000	By dividends	60,000
To royalty	500,000	By house rent	300,000
To repairs	100,000	By profit on sale of land	500,000
To salaries	300,000	By interest	75,000
To general charges	600,000	By bad debts recovered	65,000
To legal expenses	80,000	By closing stock	500,000
To provision for tax	50,000		
To R&D costs	150,000		
To bad debts	200,000		
To depreciation	700,000		
To entertainment	160,000		
To dividends	80,000		

To advertisement	250,000		
To donation	400,000		
To reserve for bad debts	150,000		
To net profit	2,510,000		
	15,075,000		15,075,000

Additional information:

1. Bad debts recovered of Rs. 4,000 were not allowed previously.
2. Rs. 10,000 donation was given to a public hospital.
3. Legal expenses include lawyer charge for briefing income tax rules to the finance director of Rs. 15,000.
4. Allowable depreciation was Rs. 650,000.
5. Purchase includes cost of a new computer of Rs. 150,000.
6. General charges include PC cost of Rs. 80,000 and income tax appeal charge of Rs. 25,000.
7. Payment of income tax of Rs. 60,000 and custom duties of Rs. 200,000 were not shown in the above Income Statement.
8. Both stocks were overvalued by 10 percent.

Required:

(a) Assessable income
(b) Statement of total taxable income
(c) Tax liabilities [10+4+2]

[TU, MBA 2060, model modified]

7. Given below is Income Statement of Dual Pole Limited. Its shares are quoted on stock exchange for the previous year.

Income Statement

Particulars	Amount	Particulars	Amount
Cost of goods sold	7,000,000	Sales	14,660,000
Salaries and wages	4,000,000	Closing stock	653,000
Rent of business premises for the year	600,000	Rent of staff quarter	156,800
R&I costs	650,000	Sales income received of old cessation business	630,200
Insurance of trading stock	50,000		
General expenses	460,000		
Depreciation	900,000		
Establishment expenses	340,000		
Municipality tax	15,000		
Bad debts provisions	25,000		
General reserve	60,000		
R&D costs	950,000		
Scientific costs	120,000		

Feasibility expenses	240,000		
Donation	36,000		
Loan interest	290,000		
Printing and stationery	44,000		
Net profit	320,500		
	16,100,000		16,100,000

Additional information includes:

1. Salaries and wages include factory wages which was paid to worker Rs. 1,955,100. It is not adjusted in the above amount of cost of goods sold.
2. General expenses include capital loss of a damage machine of Rs. 150,000.
3. Sales income includes recovery of bad debts Rs. 50,000 which was remitted in the earlier income year.
4. Loan interest includes Rs. 150,000 payment of cash at once time.
5. Establishment includes a business gift of Rs. 8,000.
6. Depreciable base for the year was Rs. 8,000,000.
7. Rent of staff quarter was not received yet to the end of the previous year.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [10+3+2]

8. Given below is Income Statement of Kasthmandap Limited. Its shares are quoted on stock exchange for the previous year.

Income Statement

Particulars	Amount	Particulars	Amount
Salaries	296,000	Sales income	476,000
Rent	80,000	Commission	190,000
Electricity and water	14,600	Share transfer fee	400
Trade expenses	90,000	Dividends from a	
Insurance	11,400	co-operative society Ltd	62,000
R&I costs of car	16,000	Sale of scrap	23,000
Legal expenses	17,000	Profit on sale of	
Guest and hospitality	14,500	investment	12,000
R&I costs of furniture	9,600	Refund of demurrage	11,800
Staff bonus	18,000	Refund of customs	
Premium paid on		penalties	12,200
redemption of debenture	24,000		

Loss on sale of business assets	10,200		
Audit fee	3,000		
Depreciation	16,000		
Traveling allowance	4,000		
Net profit	163,100		
	787,400		787,400

Additional information:

1. Legal expenses include:
   (a) Rs. 5,000 was incurred in connection with the issue of a debenture,
   (b) Rs. 6,000 was paid to sales tax advisers in connection with sales tax appeal,
   (c) Rs. 2,500 was paid to a lawyer for contesting a case against the company for evicting the company from its premises and the balance for suits filed for recovery of debts.
2. Trade expenses include donation of Rs. 50,000 paid to an entity that is receiving exempt certificate from this year.
3. Depreciable base of the car was Rs. 220,000.
4. Premium paid on redemption of debenture referred payment of compensation against breach of a business contract.
5. Dividend income include:
   (a) Dividend of co-operative society limited running for production of agro-tools Rs. 32,000 and
   (b) Dividend of co-operative society limited running for financial transactions Rs. 32,000.

Required:

(a) Assessable income from business
(b) Statement of taxable income
(c) Tax liabilities [10+3+2]

9. Given below is Income Statement of Agro Limited. Its shares are quoted on stock exchange for the previous year.

Income Statement

Particulars	Amount	Particulars	Amount
Opening stock	500,000	Sales	9,150,000
Purchase of raw material	5,500,000	Amount derived from	
Freight and insurance	600,000	accepting a condition	

Salaries and wages	1,550,000	in respect of business	137,000
Audit fee	20,000	Rent from staff quarter	100,000
Legal expenses	50,000	Closing stock	800,000
R&I cost of machinery	44,000		
Staff welfare expenses	20,000		
General charges	28,000		
Interest on OD	200,000		
Commission for loan	10,000		
Reserve for bad debts	5,000		
Bad debts written off	40,000		
Depreciation	10,000		
Interest	77,000		
Rent	16,000		
Contribution to RF	125,000		
Provision for income tax	50,000		
General reserve	100,000		
PC costs	1,050,000		
Net profit	192,000		
	10,187,000		10,187,000

Additional information includes:

1. Legal expenses incurred for:
   (a) Rs. 10,000 paid to a junior lawyer for conducting income-tax appeal,
   (b) Rs. 10,000 paid to director in advance for smuggling goods from India, a profit of Rs. 30,000 was made from that smuggling which is not shown in income statement.
   (c) Rs. 30,000 was paid to a senior lawyer to defend the title of the business asset.
2. General charge includes:
   (a) Rs. 15,000 emergency insurance premium
   (b) Rs. 10,000 donation to a hospital (An NGO and a Private Company operate to it and it is going to receive exempt certificate from current income year).
   (c) Rs. 3,000 paid to a carpenter who was repaired some furniture of staff union.
3. Depreciation was written down only office furniture. Depreciable base value of the machinery was Rs. 550,000.

4. Staff welfare expenses include Rs. 15,000 as cost of well construction nearby the business premises.
5. Interest of OD includes commitment charge of another loan of Rs. 20,000 which is not taken by the taxpayer. It is possible to take in this current year.

Required:

(a) Assessable income from business

(b) Statement of taxable income

(c) Tax liabilities [10+3+2]

10. The Income Statement of XYZ Ltd. For the previous year is as under:

Expenses	Amount	Income	Amount
Opening stock:		Sales	4,950,000
Raw materials	150,000	Closing stock:	
Finished products	409,000	Raw material	160,000
Work-in-progress	350,000	Finished products	390,000
Purchase	1,900,000	Work-in-progress	240,000
Wages	850,000		
Gross profit	2,081,000		
	5,740,000		5,740,000
Salaries	480,000	Gross profit	2,081,000
Conveyance	25,000	Dividend income	12,000
Rent, rates and taxes	6,900	Net gain from	
Brokerage	50,000	disposal of business	
Interest	70,000	liabilities	43,000
R&I costs	15,000		
Bad debts	8,000		
General charges	23,000		
Depreciation	360,000		
Reserve: future loss	25,000		
Provision for tax	35,000		
R&D costs	390,000		
PC costs	280,000		
Net profit	368,100		
	2,136,000		2,136,000

Compute assessable income and tax liability considering the following additional statement as furnished in management representation letter:

1. Raw materials stock has been valued at cost while stock of finished goods at the close of every accounting period has uniformly been valued at 5 percent under cost.
2. Conveyance expenses include a sum of Rs. 15,000 representing expenses incurred by a director in traveling abroad for the purpose of negotiating the purchase of a plant and machinery. The machinery was ultimately acquired in Bhadra of current year. It was used since the first Poush of current year.
3. Interest includes a sum of Rs. 15,000 paid on a loan taken for the purchase of new machinery. The machinery in question was delivered to the company and brought into use in Asvin of the current income year.
4. R&I costs include a sum of Rs. 10,000 representing the cost of replacing one of the company's sold complement of five boilers. The new boiler was identical in shape and size to the replaced boiler. The replacement became necessary as the boiler was severely damaged due to an accident and became useless.
5. Bad debts represent an irrecovered sum of Rs. 25,000 standing to the debit of a supplier's account since last five years for he was paid twice during the said year in respect of the same transaction. On the supplier's refusal to return the over-payment of Rs. 25,000 the matter was taken by the company to the court which gave a decree in favor of the company in three year earlier for the full amount of Rs. 25,000. The supplier, however, become bankrupt and the solicitor of the company advised in previous year that there was no possibility of any realization. The company thereupon wrote off the outstanding amounts.
6. Depreciation debited to the account represents also the depreciation admissible in assessment. The written down value as per books and as per income tax records is same.

10.12 TAXATION OF COOPERATIVES

Levy of tax upon co-operative business started since 2002 after the execution of ITA 2002. However, taxation of co-operative varies among the nature of businesses. Some co-operative businesses are exempted from payment of tax now.

10.12.1 Concept and Meaning

Generally, cooperation means the act of working together to achieve a common goal. Activities of cooperation are much older than the man himself. Many economists defined cooperation in their own way. Hajela (1997) mentions that there are chiefly three schools of thought: (1) The Cooperative Enterprise School of the Pace-makers of Cooperative Yardstick School, (2) The Cooperative Commonwealth School, and (3) The Socialist Cooperative School.

According to the Cooperative Enterprise School, a cooperative institution is a voluntary association of independent economic units, organized, capitalized and run by, and for its members, providing or marketing goods and services on cost-to-cost basis to their members. The chief aim underlying the organization of such institutions is the advancement of economic interests of members and protection and maintenance of the economic independence of small producers by making up the economic deficiency through pooling of resources and thus bringing to them the economics of large-scale production.

The second, the Cooperative Commonwealth School of thought is not merely contented with improving the economic position of the members within the existing framework but also aims at eliminating the competitive, capitalistic system and replacing it by one, which is based on mutual cooperation. This type of cooperatives has been adopted in developing countries.

The third, Socialist Cooperative School believes that the cooperative movement can be an important instrument in furthering the socialist progress. It is based on Marxist-Leninist theory. According to Lenin, cooperatives can help the transformation from capitalism and finally to communism. Accordingly, a cooperative society has been defined as an "economic and social organization of the working people, serving not only interest of the members, but also social progress" which "promotes, safeguards and realizes the interest and aspirations of the working people."

There are various definitions given by prominent cooperative leaders, among them some are given as below.

Calvert defines, cooperation is, “a form of organization wherein persons voluntarily associate together as human beings on a basis of equality for the promotion of economic interests of themselves.” In Holyoake’s words, cooperation is “a voluntary concert with equitable participation and control among all concerned in any enterprise.’ Similarly Plunkett defines, it is nothing but “self help made effective by organization.”

Lambert’s definition has received the widest recognition. It has been supported by cooperative leaders throughout the world. Lambert says that:

> A cooperative society is an enterprise formed and directed by an association of users, applying within itself the rules of democracy and directly intended to serve both its own members and the community as a whole.

Similarly, other scholars have also defined cooperation. These are given as below.

According to Maldenatz, cooperative enterprises are “associations of persons, small producers or consumers who come together voluntarily to achieve some purpose by reciprocal exchange of services, through an economic enterprise working at their own risk and with resources to which all contribute.” Watkins defines cooperation as “system of social organization based on the principles of unity, economy, democracy, equity and liberty.” In Antoine Antoni’s words, “a cooperative is an association of persons pursuing aims of social, economic and educational character and forming for their attainment an enterprise which operates in accordance with the principles of democracy and collective ownership.” Hough says that, “cooperation may be defined simply as voluntary association in a joint undertaking for mutual benefit.” According to Seligman, “cooperation in its technical sense means the abandonment of competition in distribution and production and the elimination of middlemen of all kinds.”

A cooperative society, thus, can serve various aims and economic systems and can cater to the needs of politically, socially and religiously divergent people at one and the same time. The essence of cooperation, thus, lies in practice and not in theory.

10.12.2 Principles of Cooperation

The cooperative societies have to follow certain principles which form the very foundation of any cooperative activity. These principles have

been the guiding force behind the development of the cooperative movement in the world. Those are: -universality, democratic control, self-help and mutual help, unity or political and religious neutrality, the principles of liberty, limited interest on capital and patronage rebate and principle of publicity.

10.12.3 Classification of Cooperative Societies

Cooperatives can be classified according to their activities in multiple forms. The main classifications are as under:

Table 10.3: Classification of cooperative societies

Basis	Cooperatives	Activities
Functional point of view	1. Productive 2. Auxiliary	In this group the societies dealing with the supply of goods, credit, housing and other services and marketing of goods and investment of surplus funds are included.
Legal point of view	1. Unregistered 2. Registered	There are three broad types of societies which are included under this group: (a) Societies with unlimited liabilities, (b) Societies with multiple liabilities; and (c) Societies with limited liability.
Area of operation	1. Urban 2. Rural	According to the area of operation societies have been divided into two groups: Urban and Rural.
Level of operation	1. First classification 2. Second classification	According to level of operation there are two classifications. In the first classification societies have been divided into primary, secondary, tertiary and apex. In the second classification there are local, regional, national, supranational or international cooperatives societies.
Sector of economy	1. Agriculture 2. Small industries 3. Retail and wholesale 4. Service trade	According to the sector of economy the societies are engaged in: (a) Agriculture, (b) Small industries, (c) Retail and wholesale and (d) Service trade.
Economic status of the member	1. Producer 2. Consumers 3. Workers	According to the economic status of the members the cooperative societies are classified into (a) producers: farmers, traders, and craftsmen (b) Consumers and (c) Workers

10.12.4 Co-operative Business Taxation

ITA 2002 maintains that the following provisions to co-operative businesses.

☐ Exemption of Income Tax

Incomes derived by cooperative societies, registered under Cooperative Act 1991 (2048), from business mainly based on agriculture and forest products such as sericulture and silk production, horticulture and fruit processing, animal husbandry, diary industries, poultry farming, fishery, tea gardening and processing, coffee farming and processing, horticulture and herb processing, vegetable seeds farming, bee-keeping, honey production, rubber farming, floriculture and production and forestry related business such as lease-hold forestry, agro-forestry, cold storage established for the storage of vegetables and business of agricultural seeds, insecticide, fertilizer and agricultural tools (other than machine operated) and rural community based saving & credit cooperatives are exempt from tax.

☐ Exemption of Dividend Tax

Dividends distributed by such societies are also exempt from tax.

☐ Tax Rate

Saving and Credit Co-operative limited operated in other area (except community based on rural area) are taxed at the rate of 30 percent as equivalent to financial institution.

CASES AND SOLUTIONS

1. The following is Income Statement of Everest Saving & Credit Cooperative [not based on rural community] Ltd for the previous year.

Particulars	Amount	Particulars	Amount
Interest on deposit	750,093	Interest from lending and credit	1,150,050
Interest on borrowing	43,560		
Staff salary & allowance	350,000	Interest from investment	230,690
Cont. to retirement fund	32,000	Other income (service charge)	145,000
Office rent	120,000		
Wages to office runners	36,000	Dividend income received from resident company	85,553
Advertisement	15,200		
Guest and hospitality	4,300		
Rates and taxes	2,600		
Newspaper and bulletin	1,470		
Conveyance	3,980		

Communication exp.	12,090		
PC costs	120,000		
Net profit	230,000		
	1,611,293		1,611,293

Additional information:

1. Rates and taxes include income tax of Rs. 2,500.
2. Interest from lending and credit includes interest from five percent staff loan of Rs. 15,000. The fair market rate of such type of loan was 12 percent.
3. Interest on borrowing includes private loan of manager of Rs. 25,000. The manager had taken loan from a commercial bank making an understanding with cooperative to reduce from salary. However, he has received full salary.
4. One fourth portion of office space is provided to manager as a resident which was passed by board meeting.
5. Depreciation allowance was not calculated for the previous year. Detail of assets holding by co-operative is given as below.

Opening value of assets

(a) Furniture, fixture and office equipment Rs. 250,000
(b) Vehicle [a Santo car] Rs. 250,000
(c) Value of lease property Rs. 100,000 [lease agreement 8 years]

Purchase during the year

(a) Office computers Rs. 90,000 [purchased on Magh]
(b) Generator Rs. 150,000 [purchased on Aswin]

Required:

(a) Amount of depreciation and depreciated value of the assets
(b) Assessable income from cooperative business
(c) Tax liabilities [3+10+2]

Solution:

Calculation of profit and gains and assessable income from business of Everest Saving and Credit Co-operative Limited (not based on rural community) for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM BUSINESS			
INCLUSIONS		Amounts	Amounts
1	Service fee: (1) Interest from lending & credit 1,150,050 (2) Other income 230,690	1,380,740	
2	Income from investment that is directly connected to business	145,000	
3	Difference of actual interest and interest as per market rate in case of a soft loan	21,000	
Total inclusions		1,546,740	1,546,740

DEDUCTIBLE EXPENSES INCURRED TO EARN INCOME FROM BUSINESS			
1	General deductions [w/n 1]	575,140	
2	Interest expenses	768,653	
3	Depreciation allowance [w/n 2]	162,500	
4	PC costs	20,223.50	
Total of deduction		1,526,516.5	1,526,516.5
Business income			20,223.50
DEDUCTIBLE LOSSES			
	Offsetting of unrelieved loss of previous year		-
Assessable income			20,223.50

CALCULATION OF TAXABLE INCOME

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from business	20,223.50
2	Assessable income from investment	-
Assessable income		20,223.50
DEDUCTION FROM ASSESSABLE INCOME		
	Donation to exempt organization	-
Taxable income		20,223.50

CALCULATION OF TAX LIABILITIES

TAXABLE BASE		20,223.50
1	Taxable income Rs. 20,223.50 @ 30%	6.067.05
CALCULATION OF ADDITIONAL TAX		
2	1.5% of the taxable income Rs. 20,223.50	303.35
Tax liabilities		6,370.4

Working note:

1. General deductions [business]

S. No.	Particulars	Total exp.	Non-deductible	Deductible
1	Staff salary and allowances	350,000		350,000
2	Cont. to retirement fund	32,000		32,000
3	Office rent	120,000		120,000
4	Wages to office runners	36,000		36,000
5	Advertisement	15,200		15,200
6	Guest and hospitality	4,300		4,300
7	Rates and taxes	2,600	2,500	100
8	Newspaper and bulletin	1,470		1,470
9	Conveyance	3,980		3,980
10	Communication expenses	12,090		12,090
		577,640	2500	575,140

2. Depreciation allowance

Pool	B	C	D	E	Total
Opening balance	250,000	250,000	-	100,000	600,000
Absorbed addition	60,000	-	150,000	-	210,000
Disposal during the year	-	-	-		-
Depreciable base	310,000	250,000	150,000	100,000	810,000
Depreciable rate	25%	20%	15%	1/8	
Depreciation allowance	77,500	50,000	22,500	12,500	162,500
Depreciated value	232,500	200,000	127,500	87,500	647,500
Unabsorbed addition	30,000	-	-	-	-
Unabsorbed R&I cost	-	-	-		-
Unabsorbed PC cost	-	-	-		-
Unabsorbed R&D cost	-	-	-		-
Value for the next year	262,500	200,000	127,500	87,500	677,500

3. Calculation of PC costs

1	Total of inclusion from business		1,546,740
Deductions:			
1	General deduction	575,140	
2	Interest expenses	768,653	
3	Depreciations	162,500	1,506,293
Adjustable taxable income			40,447
	50% of the adjusted taxable income		20,223.5
	PC costs		20,223.5
Thus, deduction of cost of PC is Rs. 20,223.50.			

Clarification:

- Dividend received from resident company is final withholding amount.
- Cost incurred for the manager by providing resident is deductible expenses as business expenses, however, that is quantified to the employee only.

REVIEW QUESTIONS AND CASES

1. Define co-operation. Write down five objecitves of co-operatives.
2. Describe different school of thoughts of co-operation.
3. The following is Income Statement of Nepal Co-operative Limited situated in Kathmandu Metropolitan City for the previous year.

Income Statement

Particulars	Amount	Particulars	Amount
Interest	1,050,961	Interest income	1,422,516
Staff salary	450,567	Service fee	724,490
Office rent	60,000	Registration fee	6,100
Telephone	16,289	Miscellaneous	
Electricity	28,788	income	1,550
Water expenses	13,840	Bank interest	297,584
Guest and hospitality	18,458	Entrance fee	29,800
R&I costs	81,479	Penal interest	10,421
Transportation and fuel	20,208		
Advertisement	10,743		
Newspaper & magazine	2,600		
Business promotion	12,523		
Tiffin expenses	12,835		
Wages	32,500		
Annual general assembly	65,000		
Printing and stationery	65,663		
Training	14,500		
Insurance	2,409		
Depreciation	87,620		
Audit fee	15,000		
Amortization	40,740		
Miscellaneous	88,743		
Net profit	300,995		
	2,492,461		2,492,461

Management of the Limited disclosed the following information: Telephone includes private charge of manager's house Rs. 2,500.

1 R&I costs were incurred for: Computer Rs. 22,500; Furniture and Fixture Rs. 20,500; Safe and Others Rs. 18,400 and Office equipment Rs. 20,079.
2 Allowable depreciation allowance was Rs. 85,200.
3 Annual general assembly includes cost of private transportation of manager Rs. 2,600.

Required:

(a) Assessable income from business
(b) Tax liability [6+2]

4. Sagarmatha Co-operative Society Limited disclosed the following Income Statement for the previous year.

Income Statement

Particulars	Amount	Particulars	Amount
Interest	28,022,900	Interest income	39,628,900
Staff salary	1450,567	Service fee	922,220

Office rent	160,000	Registration fee	15,400
Telephone	216,200	Miscellaneous income	22,980
Electricity	128,700	Bank interest	22,800
Water expenses	83,800	Entrance fee	59,260
Guest and hospitality	28,000	Penal interest	50,840
R&I costs	89,600	Net gain derived from	
Transportation and fuel	40,200	the disposal of	
Advertisement	200,700	business assets	300,000
Newspaper and magazine	82,600		
Business promotion	412,000		
Tiffin expenses	92,800		
Wages	132,700		
Annual general assembly	165,000		
Printing and stationery	85,600		
Training	54,500		
Insurance	92,400		
Depreciation	387,620		
Audit fee	55,000		
Amortization	140,000		
Miscellaneous	188,000		
Net profit	8,713,513		
	41,022,400		41,022,400

Management of the Society Limited disclosed the following information:

1. Advertisement expenses include payment of penalty paid to NRB Rs. 160,000.
2. Wages includes installation cost of computer including software updates Rs. 30,500.
3. Annual general assembly includes best staff award of the year paid to a senior staff Rs. 20,000.
4. Insurance includes insurance premium of the manager's house for the previous year Rs. 16,000
5. Water expenses include advance payment of the next year of Rs. 6,000.
6. Miscellaneous include donation amount given to National Research Institute of Rs. 122,000.
7. Business promotion expenses include dinner expenses incurred in Soaltee Hotel for the society's guest and staffs of Rs. 55,000.
8. The Society Limited has 4,450,000 of the previous year which is not adjusted by the gain.

Required:

(a) Assessable income from business

(b) Tax liability [6+2]

Chapter 11

Investment Income

11.1 CONCEPT AND MEANING

Investment is the last and remaining head of income taxation. Source of income which does not particularly fall under any one of other two heads of income like business and employment is to be calculated and carried to charge under the head "income from investment". ITA 2002 adopts principles of factors of production – land, labor and capital – to design heads for income taxation. It is also considered a best method of head designing of income taxation all over the world. However, it creates difficulty in calculation sometime. For example, an employee if theft a money from the treasury of his employer; what will be the head of income? In the sense of theft, a critical thing is that, it is not received by the employer. The theft money falls neither under business nor

investment, and nor employment. Tax law does not permit exempt from payment of tax to illegal or theft money. Is it practicable under the method of final withholding payment for theft money? Similarly, salary of Member of the Parliament, examiner's fee, part-time teacher's salary (if they are not final withholding) is also problem for appropriate headings. These income are generally borne from labor however, these do not involve the basic norms of employment. Income from employment, investment, or other such occasional income earning from whatever so reason may be treated under one head such as 'personal income' if we make another new separate head. Thus, income from investment must be a residuary head of income taxation. However, in Nepal, it may occur in future. Investment may be defined in many ways. Some substantial definitions are presented here. Black's Law Dictionary defines:

> Investment means expenditure to acquire property or other assets in order to produce revenue; the asset so acquired. The placing of capital or laying out of money in a way intended to secure income or profit from its employment. To purchase securities of a more or less permanent nature, or to place money or property in business ventures or real estate, or otherwise lay it out, so that it may produce revenue or gain or both in the future.

According to §2(al) investment means an act of holding or investing one or more assets of a similar nature that are used in an integrated fashion but excludes the act of holding assets, other than assets for personal use by the person owning the asset or investing amount on such assets, or employment or business. However, non-business chargeable asset is taken into account of investment.

Thus, investment is usually an earning activity mostly consisting of the provision of capital. It justifies the following:

Capital is given by holding one or more assets of a similar nature. It means asset may be one or more but return is in the form of similar nature.

EXAMPLE 11-1 If a person holds block of equity share from two banks, three hotels, and four insurance companies etc. is a single investment. Similarly, a house rented out with its associated fitting is also called single investment.

EXAMPLE 11-2 If a person holds equity share of a bank, lending money for an interest and rented out house for rent are investments of different assets for similar nature of income.

According to §2(bc) an asset is distinct as a tangible or intangible asset such as currency, good will, know-how, property, an owner's interest in a foreign branch, a right to income or future income and a part of asset.

> **EXAMPLE 11-3** If a person holds copy right and makes income from this asset is an income from investment of intangible asset. Similarly, if he rents his house and receives money is an income from investment of tangible asset.

Thus, income earned either intangible assets or tangible assets or short-term or long-term that may be income from investment if a person holds assets and invest them to earn income.

11.2 INCLUSIONS FROM INVESTMENT INCOME

A person's income from an investment for an income year should be taken as the person's profits and gains from making an investment computed on that basis. In computing a person's profits and gains from an investment for an income year the following amounts derived by the person during the year should be included.

☐ **Dividend Income [§ 9(2)(a)]**

Distributions from a company to its stockholders, in the form of ordinary dividends, capital gain distributions, or nontaxable distributions. Dividends are usually received in cash, but are also distributed as additional stock, stock rights, property, or services. A Company out of its profits pays dividend. Thus, in ordinary sense dividend is an income received by the shareholder of a company, a proportionate to his shareholding out of the profits of the company. However, the lawmakers in defining dividend has added certain other receipts which otherwise may not be called dividends.

Payment of dividends depends upon the character of the payer whether it is final withholding or not. For final withholding payment the payer i.e., the company must be resident. The law does not consider the character of the recepient whether he is resident or not. A company which is not incorporated or not established under the laws of Nepal or a company that has had not an effective management in Nepal during the income year is known as non-resident company. Thus, dividends paid by resident company are final and if those are paid by other than resident company are non-final.

> **EXAMPLE 11-4** Thin and Fat are the shareholders of a resident company. But, Thin is resident and Fat is non-resident for an income

year. In the same year, if that resident company distributed its dividend to them, the dividend income is final withholding.

EXAMPLE 11-5 Shorter and Longer both are shareholders of a limited company (non-resident). Status of the shareholders is resident and non-resident respectively in an income year. In the same year, both if received dividend income from that non-resident company, the amount of dividend should account for chargeable income.

☐ Interest Income [§ 9(2)(a)]

Judge Schreiner asserts, the interest is the fruit of the money and comes from where the money is, irrespective of where the contract was made or the interest is payable.

Interest is the compensation allowed by law or fixed by the parties for the use or forbearance of borrowed money. The interest may be born by the basic cost of borrowing money or buying on installment contract; use of the money or cost of using credit or funds of another etc.

Interest income involves both features of final and non-final. It considers both character of recipient and payer. These may be separated as given in the following table 11.1.

Table 11.1: Characteristics of payer and recipient of interest

Characters of payer	Characters of recipient	Final/non-final
Banks, financial institutions or debenture issuer entities or listed companies	An individual other than conducting a business	Final
Bank, financial institution or debenture issuer entity or listed company	An individual if involved in conducting a business or entities	Non-final
Entities other than banks, financial institutions or debenture issuer entities or listed companies	Any resident or non-resident persons	Non-final

EXAMPLE 11-6 An individual natural person who is involved in conducting a business, if receives interest income from limited banks or financial institutions or debenture issuer entities or listed company, should be included in income from investment of that person.

EXAMPLE 11-7 Business entities having sources in Nepal if receive interest income from any person - individual or entities by whatever so reason, they must include this amount of interest in their business income.

EXAMPLE 11-8 Any resident or non-resident persons if receive interest income from any persons other than listed company, or debenture issuer entities, or financial institutions, the persons should include this amount of interest in investment income.

☐ Rent from Lease of Property [§ 9(2)(a)]

Rent means consideration paid for use or occupation of property. In a broader sense, it is the compensation or fee paid, usually periodically, for the use of any rental property, land buildings, equipment etc. The rent is defined as:

> Rent in law, periodic payment by a tenant for the use of another's property. In economics, its meaning is more complex, but since the word rent means any income or yield from an object capable of producing wealth, its limitation to a more special sense is somewhat arbitrary and justified only by a general consensus of opinion and usage. The term rent is now ordinarily used in the broad sense and, besides the return from land, includes the return from such things as tools, machinery, and houses. Objects are rented for a limited period of time and are generally expected to be returned in their original condition. The early English writers on economics (16th–18th cent.) used the word to mean interest on a loan, but its economic meaning gradually narrowed to the sense of the return on land. Modern rent doctrine began in the 18th century. The physiocrats centered their economic system on land. They believed that rent was measured by the net product i.e., the surplus over the cost of production (the Columbia Encyclopedia, 2006).

Thus, rent may be used in a narrow as well as broad sense.

Rent of land or building and associated fittings has to be included in the income from investment. But, it may be final or non-final. It does not prescribe the character of recipient but prescribe the character of payer. The rent of lease of property having a source in Nepal and that is received by an individual other than conducting a business is treated as final withholding payment. But rent income other than final withholding payment is the chargeable income.

Rent of lease of property received by an individual natural person who is conducting a business is chargeable to tax under the income from investment. But, if received by other entities having source in Nepal and that is conducting a business is chargeable to tax for income from business.

> **EXAMPLE 11-9** A natural person having source in Nepal and that is conducting a business, if received rent income from entities by letting his house property, is chargeable to tax in investment income.
>
> **EXAMPLE 11-10** A natural person having source in Nepal and that is not conducting a business, if received rent income from individual by letting a property, is chargeable to tax but does not fall under income from investment.

☐ Gain Received from Investment Insurance [§ 9(2)(a)]

Gain received from investment insurance is treated as final or non-final by the characteristics of the payer. If payer is resident the proceeds will be final and if payer is non-resident the payment will be chargeable to tax as investment income. A person or an associate of a person having source in Nepal if received gain from investment insurance from resident person is the final withholding payment. If it received from non-resident person it is to be included in the investment income.

> **EXAMPLE 11-11** A person received gain from investment insurance Rs. 50,000 out of its total amount of insurance Rs. 200,000 from a non-resident person, the person should include this gain in investment income.

☐ Payments Towards Natural Resources [§ 9(2)(a)]

Payment received toward natural resource such as for the use of land for the purpose of any kind of mining like metal, gas, stone, sand, water etc. is chargeable to tax under the income from investment.

☐ Royalty Income [§9(2)(a)]

The OECD Model Convention defines:

> The term 'royalties' means payments of any kind received as a consideration for the use of or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Therefore, royalty is a compensation for the use of intangible property, usually copyrighted material or natural resource, expressed on a percentage of receipts from using the property or as an account per unit produced. Payment which is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold or to an inventor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property.

Royalty income is always included in income from investment. It may be less-tax income. Less tax royalty implies that tax should be deducted at source and the net amount be paid to the royalty-holder. Royalty is always presumed to be less-tax unless specified to be tax-free or gross.

☐ Gain from an Unapproved Retirement Fund's Interest [§9(2)(a)]

The gain from an unapproved retirement fund's interest may be final or non-final. If it is received by the person from non-resident person it will be chargeable to tax in the investment income. But if it is received from resident person becomes final withholding payment.

> **EXAMPLE 11-12** A business organization kept itself its employee's retirement fund for 10 years. After 10 years it paid all of employee's that unapproved retirement benefits Rs. 120,000 including interest Rs. 20,000. In this situation, Rs. 20,000 is the gain of the unapproved retirement fund. If it received from non-resident person, the recipient should include this gain in investment income. If it received from resident person, it regard for final withholding.

☐ Retirement Payment and Approved Retirement Fund [§9(2)(a)]

To calculate the income of an individual from an interest on an approved retirement fund or retirement payment paid by the Government of Nepal, it is taken in the form of a lump sum payment, whichever is higher between 50 percent of that payment or Rs. 500,000. These are deducted from that amount and the remaining are treated as a gain from the disposal of a non-business chargeable asset of an investment and it is considered as final withholding payment.

☐ Net Gain from the Disposal of Non-business Chargeable Assets [§9(2)(b)]

A non-business chargeable asset includes securities or interest of an entity as well as land and building of the following nature:

1. A private residence of an individual that has been owned continuously or intermittently in total for less than three years.

2. Land and a private residence of an individual that is disposed for more than Rs. 10 million or
3. Assets of an individual that is disposed by way of any type of transfer other than sales and purchases made beyond three generations.

Net gains from the disposal of non-business taxable assets of an investment are calculated by deducting the following losses from the total gains from the disposal of non-business taxable assets of the investment during the year.

Table 11.2: Calculation of net gain from non-business chargeable assets

Net gain from disposal of non-business taxable assets		**Amount**
Equals	The total gains from the disposal of non-business taxable assets of the investment.	xxx
Less	The total of all losses suffered from the disposal of non-business taxable assets of the investment during the year;	(xx)
Less	Any unrelieved loss out of net loss from any losses of business or investment of the person during the year; and	(xx)
Less	Any unrelieved loss out of net loss of any previous income years from the investments, any business, or other investment of the person.	(xx)

The net gain from disposal of non-business chargeable assets is chargeable to tax in income from investment. But, it is taxed at the rate of 10% as capital gain.

☐ Gain from Disposal of Depreciable Assets [§9(2)(c)]

The excess amount of incoming over the depreciation cost including outgoing on the disposal of depreciable assets of the investment of the person is included in investment income.

☐ Gifts Received by the Person in Connection to the Investment [§9(2)(d)]

If any person received any gift, whether convertible into cash or not, out of his investment in any income year, the amount equivalent to the market value of such gift should be included in income from investment.

☐ Amount Derived from Accepting a Restriction [§9(2)(f)]

Any amount received as consideration for accepting a restriction in connection to the investment is chargeable to tax.

☐ Amount Received from Changing an Accounting Method

Any proceeds arising from changing an accounting method of a person during the year in connection to the investment are chargeable to tax.

☐ Amount Received as Considered from Devaluation of Currency

Any excess amount derived by reason of devaluation of currency or valuation of a currency in connection to the investment is treated as an income.

☐ Bad Debts Recovered that was Remitted in Earlier Income year

If a person owes money and it could not be collected is called bad debt. There may be two types of bad debts such as business and non-business. Again non-business bad debts can be classified as employment, investment and capital bad debts. Amount derived from bad debts recovered and remitted in earlier income year in connection with the investment is chargeable income. But, the account of the person must be in accrual method.

1. **Amount decided from soft loan:** Interest payment of loan by a person if is lower than the market practice and standard interest rate must be treated on equity basis. The difference between market standard rate and paid rate is to be included in investment income if it is connected with the investment.

   EXAMPLE 11-13 An individual provided loan for interest to another person where the rate of interest was decided five percent. But, prevailing market rate of interest for such loan was 10 percent. In this condition, additional income is to decide from the difference of interest rate and it should include in income of both payer and payee.

2. **Indirect payment:** A due of a person if paid by other is known as indirect payment. If it is connected with the investment income the beneficiary is to be taxed on the beneficial amount.

   EXAMPLE 11-14 Suppose that an individual "X" was obliged to another person "Y" by Rs. 200,000. If it is paid by any other third person "Z" the amount of that obligation is to include in investment income of the individual "X".

☐ Amount Received from Jointly Owned Investment

If two or more persons hold property such as a savings account, bond, or stock or tenant, each person's share of any interest or dividends or rent from the property is to be determined by their respective shares. For the

purpose of calculating a person's income from investment the portion of such investment is to be included in income.

EXAMPLE 11-15 Two resident individuals, Jaya and Bijaya entered into a joint ownership arrangement without establishing a legal person. Jaya contributed 60 percent while Bijaya 40 percent for that arrangement. In an income year, if income and expenses stood for Rs. 20,000 and Rs. 8,000, their arrangement is calculated as:

Particulars	**Total**	**Jaya**	**Bijaya**
Total receipts	20,000	12,000	8,000
Deductible expenses	8,000	4,800	3,200
Net income	12,000	7,200	4,800

Thus, Jaya and Bijaya should include their respective income and deductions as given above in their individual income calculation

☐ **Compensation Amount**

If a person or an associate of a person derives a compensation amount, including a payment under insurance that compensates the loss of investment is to be included in investment income.

☐ **Other Amounts (if any)**

Other similar types of income, which is connected, with the investment income if derived by the person during the year are to be included for tax purposes.

11.3 AMOUNTS EXCLUDED FROM INVESTMENT INCOME

Amounts that are exempted and final withholding are excluded in calculating the profits and gains from investment are as given below:

1. Tax exempted income [§10]
2. Taxation of dividend [§54]
3. Controlled foreign entities [§69]
4. Final withholding payment [§92]
5. Amounts those are included in calculating the person's income from any employment and investment.

For details please refer to chapter 4: Exempt Amounts and Other Concession, 5: Special Provisions, 6: Withholding, and 8: Deductions that are Not Allowed.

11.4 DEDUCTIONS FROM INVESTMENT INCOME

Expenses that can be subtracted from an individual's investment income to obtain the profit and gains from investment are the deductions. The following costs and expenses are allowed for deduction while computing person's income from investment.

1. General deduction [§13]
2. Interest [§14]
3. Repair and improvement (R&I) costs [§16]
4. Depreciation allowance [§19]

For details, please refer chapter 7: Deductions from Business and Investment Income

5. Business or investment loss [§20]

For details, please refer to chapter 12: Set off, Carry forward and Carry Back of Losses.

11.5 DEDUCTIONS FROM ASSESSABLE INCOME

Deductions from assessable income are common deductions from employment, investment and business income. If any person has only one source of investment income, the following deductions must allow from its assessable income.

1 Donation to exempt organization

2 Contribution to retirement fund

For details, please refer to chapter 13: Deductions from Assessable Income.

11.6 REDUCTION FROM TAXABLE INCOME

If, there exists only income from investment at least three certain items may be deductible from taxable income such as: (1) reduction for family status, and (2) reduction for life insurance premium.

11.6.1 Reduction from Liability

The tax liability may be reduced by the following two items:

1. Medical tax credit
2. Foreign tax credit [if foreign source exist]

11.7 CALCULATION SHEET FOR INCOME FROM INVESTMENT

There are separate sheets of form for calculating return of income from each head: (1) income from employment, (2) income from business and (3) income from investment. In addition there are some common sheets of form which are identical for all heads. Thus, for the purpose of unfussiness calculation all the essential sheets are included in the following form.

Calculation of profit and gains from investment income for the income year 20…/20…

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT			
INCLUSIONS		**Amt**	**Amounts**
1	Dividends other than final withholding [§9(2)(a)]	×	
2	Gain from investment insurance other than final withholding [§9(2)(a)]	×	
3	Interest other than final withholding [§9(2)(a)]	×	
4	Rent other than final withholding [§9(2)(a)]	×	
5	Gain from an unapproved retirement fund other than final withholding [§9(2)(a)]	×	
6	Payments for natural resources other than final withholding [§9(2)(1)]	×	
7	Royalties [§9(2)(a)]	×	
8	Net gain from disposal of depreciable assets [§9(2)(c)]	×	
9	Gift received by the person in respect of investment	×	
10	Retirement contributions, including those paid to a retirement fund in respect of the person, and retirement payments in respect of the investment; [§9(2)(e)]	×	
11	Amounts derived as consideration for accepting a restriction of investment [§9(2)(e)]	×	
12	Amounts to be included in income from adjustment While changing accounting method. [§22(6)]	×	
13	Excess amount received by the reason of exchange rate	×	
14	Recovered amounts of bad debts deducted earlier	×	
15	Difference of actual interest and interest as per market rate in case of soft loan [§27(1)(d)]	×	
16	Amounts paid to third person instead of actual payee	×	
17	Amounts derived from joint ownership investment [§30]	×	
18	Amount derived as compensation [§31]	×	
19	Other amounts to be included in profit & gains	×	
20	**TOTAL INCLUSIONS (total of 1 to 19)**	××	××
DEDUCTIBLE EXPENSES INCURRED IN THAT YEAR TO EARN INCOME FROM INVESTMENT			

21	General deduction [§13]	×	
22	Interest [§14]	×	
23	Repair and improvement costs [§16]	×	
24	Depreciation allowance [§19]	×	
25	**TOTAL OF DEDUCTIONS (total of 21 to 24)**	xx	xx
DEDUCTIBLE LOSSES			
26	Losses transferred from other business/investments in this year	×	
27	Carry forward of unrelieved business losses from previous year	×	
28	**TOTAL LOSSES (total of 26-27)**	xx	xx
29	**TOTAL DEDUCTIONS** (25+28)	xx	xx
30	**INCOME OR LOSS FROM THE INVESTMENT** (20 - 29)	xx	
31	**LOSS TRANSFERRED TO OTHER INVESTMNET INCOME** (if 30>0)	(xx)	
32	**INCOME OR LOSS FROM THE INVESTMENT** (total of 30+31)	xx	xx

CALCULATION OF ASSESSABLE INCOME INCLUDING TOTAL HEAD (if exist)

CALCULATION OF ASSESSABLE INCOME			
33	Assessable income from investment	×	
34	Assessable income from business	×	
35	Assessable income from employment	×	
36	**Assessable income** (Total of the investment, business and investment assessable income)	xx	xx
DEDUCTIONS FROM ASSESSABLE INCOME			
37	Contribution to retirement fund	×	
38	Donations to exempt organization (both)	×	
39	**TOTAL DEDUCTION FROM ASSESSABLE**	xx	xx
40	**TAXABLE INCOME (Assessable income less total deduction from assessable income)**		xx
REDUCTION FROM TAXABLE INCOME			
REDUCTIONS:			
41	(1) Individual or couple/dependency limit	×	
	(2) Pension income (if existed employment income)	×	
	(3) Disable allowance	×	
42	Life insurance premium	×	
43	Remote area allowance	×	
44	Foreign allowance (if existed employment/foreign all.)	×	
45	**TOTAL REDUCTIONS**	xx	xx

46	**TAXABLE BASE**	xx

CALCULATION OF TAX LAIBILITIES			
47	Taxable income @ 10%	×	
48	Taxable income @ 15%	×	
49	Taxable income @ 25% (in an ordinary case)	×	
51	**TAX AMOUNTS**	xx	xx

TAX CREDIT (DEDUCTION OF MEDICAL TAX CREDIT)		
52	Medical tax credit (if existed)	×

53	**TAX LIABILITIES**	×

CASES AND SOLUTIONS

1. A resident person presented the following particulars about his income for the previous year.

1. Amounts of dividend from resident company Rs. 25,000 (net).
2. Profits from unregistered partnership activities (gross) Rs. 50,000.
3. Amounts received from natural resources Rs. 175,000 (gross).
4. Interest of debenture from listed company Rs. 20,000.
5. Rent from resident entity Rs. 15,000 (net).
6. Net gain from disposal of depreciable assets Rs. 8,200.
7. Interest from domestic lending Rs. 75,000
8. Net gain from investment insurance: from resident and non-resident company Rs. 15,000 and Rs. 19,000 respectively.

He claimed the following amounts for deduction:

1. Collection charges were: (a) Dividend Rs. 150; (b) Profits Rs, 250 and (c) Natural resources Rs. 2,500
2. Legal charge of natural resources to make agreement paper Rs. 2,500
3. Agent commission to make domestic lending Rs. 750
4. Remuneration to collect income of natural resources Rs. 1,500
5. Investment amount of citizen investment trust Rs. 35,000
6. Donation to a public high school Rs. 3,000

In addition the person accepted the following:

1. The person has received 10 kilos of seeds of tomato as a dividend of the share from a co-operative which is based on agriculture and forest produce. The fair market value of that seed is Rs. 6,000.
2. Receivable profit from partnership firm is Rs. 15,000

Required:

(a) Assessable income

(b) Tax liabilities [4+2]

Solution:

Calculation of profit and gains from investment income of a resident person for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT			
INCLUSIONS		**Amounts**	**Amounts**
1	Payments for natural resources other than final Withholding payment	175,000	
2	Net gain from disposal of depreciable assets	8,200	
3	Interest other than final withholding	75,000	
4	Gain from investment insurance other than final withholding payment	19,000	
5	Profits received from partnership activity	50,000	
Total inclusions		327,200	327,200

DEDUCTIBLE EXPENSES INCURRED IN THAT YEAR TO EARN THE INCOME FROM INVESTMENT			
	General deduction [§13]:		
	(a) Collection charges of profits	250	
	(b) Collection charges of natural resources	2,500	
	(c) Legal Charges of natural resources	2,500	
	(d) Commission to make domestic lending	750	
	(e) Remuneration charges to collect natural resources income	1,500	
Total of deductions		7500	7500

DEDUCTIBLE LOSSES		-
	Total deductions	7,500

Assessable income (from investment)	319,700

STATEMENT OF ASSESSABLE INCOME		
	Assessable income from investment	319,700
	Assessable income from (business/employment)	-
Assessable income		319,700
DEDUCTION FROM ASSESSABLE INCOME		
1	Investment on CIT	35,000
2	Donations to exempt organization (both)	3,000
Total deduction from assessable income		38,000
Taxable income		281,700

CALCULATION OF TAXABLE INCOME (TAXABLE BASE)

REDUCTION FROM TAXABLE INCOME

REDUCTIONS:		
1	Individual limit	100,000
2	Pension/remote/others	-
Total reductions		100,000
TAXABLE INCOME (Taxable base)		181,700
CALCULATION OF TAX LAIBILITIES		
1	Taxable base Rs. 75,000@ 15%	11,250
2	Taxable base next Rs. 106,700 @ 25%	26,675
CALCULATION OF ADDITIONAL TAX		
3	1.5% of the taxable base Rs. 106,700	11,250
Tax liabilities		26,675

Clarifications:

1. Interest, rent and gain from investment insurance paid by a resident company and received by a person having a source in Nepal and that is not conducting a business are final withholding payments.
2. Dividend paid by a resident company is final withholding payment.
3. Dividend paid by a co-operative and that is based on agriculture or forest produce is tax exempted income.
4. Method of tax accounting for investment income concern to cash basis thus accrual account is excluded from inclusion.

2. A person "X" furnished the following receipts and payment for the previous year.

1. Royalty of a book from a publication company after withholding tax 15 percent on gross amount Rs. 85,000 (net).
2. A gift presented from the publication in kind; the fair market value of this kind was Rs. 30,000.
3. Amount received from dollar account was Rs. 70,000 but his deposition was Rs. 64,200.
4. Market value of share owned by him at the end of year was Rs. 100,000; purchase price of this share was Rs. 50,000 however, it is unrealized yet.
5. Amount received from jointly owned investment Rs. 18,000.
6. Rent of his house paid by a resident company was Rs. 50,000.
7. Amount received from sale of his inherited property house was Rs. 9,500,000. Cost of this house was Rs. 7,500,000 at the time of transfer from his deceased father to him.
8. Rent of a computer from a friend Rs. 15,000.
9. The receipt amount from subletting Rs. 75,000.
10. Amount from occasional teaching salary was (net) Rs. 9,000.

The taxpayer claimed the following deductions:

1. Collection charge of royalty, gift and rent income Rs. 4,500.
2. Rent of the subletting property Rs. 65,000.
3. Depreciation of computer Rs. 2,600.
4. Interest of loan for jointly owned investment Rs. 3,600.
5. Retirement contribution contributed by both employer and employee Rs. 46,000.
6. Donation to exempt entity Rs. 6,000.

In addition he also submitted the assessable income from his employment Rs. 170,000 including pension income Rs. 15,000.

Required:

(a) Assessable income from investment

(b) Tax liability [5+5]

Solution:

Calculation of profit and gains from investment income and tax liability of a person (X) for the income year 2063/064

CALCULATION OF PROFIT AND GAINS FROM INVESTMENT			
INCLUSIONS		**Amounts**	**Amounts**
1	Royalties	100,000	
2	Gift received by the person with respect to investment	30,000	
3	Excess amount received by the reason of exchange rate	5,800	
4	Amounts derived from joint ownership investment	18,000	
5	Rent other than final withholding	15,000	
6	Other amounts to be included in profit and gains (rent from subletting)	75,000	
TOTAL INCLUSIONS (total of 1-6)		243,800	243,800

DEDUCTIBLE EXPENSES INCURRED IN THAT YEAR TO EARN THE INCOME FROM INVESTMENT				
1	**General deduction [§13]:**		68,136	
	(a) Collection charges [w/n1]	3,136		
	(b) Rent of subletting	65,000		
2	Interest		3,600	
3	Depreciation allowance		2,600	
Total of deductions			74,336	74,336

DEDUCTIBLE LOSSES (if any)	
	-

Total deductions	74,336
Assessable income (from investment)	169,464

STATEMENT OF ASSESSABLE INCOME		
1	Assessable income from investment	169,464
2	Assessable income from employment	170,000
Assessable income		339,464

DEDUCTIONS FROM ASSESSABLE INCOME		
1	Contribution to retirement fund	46,000
2	Donations to exempt organization	6,000
Total deduction from assessable		52,000
Taxable income		287,464

REDUCTION FROM TAXABLE INCOME		
REDUCTIONS:		
1	Individual limit	100,00
2	Pension income	15,000
Total of reductions		115,000

Taxable income/base		172,464
CALCULATION OF TAX LAIBILITIES		
1	Taxable income/base Rs. 75,000@ 15%	11,250
2	Taxable income/base Rs. 97,464@ 25%	24,366
CALCULATION OF ADDITIONAL TAX		
3	1.5% of the taxable base Rs. 97,464	1,461.96
Tax liabilities		37,077.96

Working note:

1. Calculation of collection charges

1	Total charges	4,500
2	Total of collected income	165,000
3	Total of inclusion amounts	115,000
Deductible collection charges [1/2×3]		3,136

Clarifications:

1. Amount received from sale of inherited residential house below Rs. 10 million is exempted from payment of tax.
2. Profit from share before realization is not income.

3. Amount received from occasional teaching salary is final withholding payment.
4. Nepal has agreed Double Taxation Avoidance Agreement (DTAA) with nine countries: Australia, China, India, Korea, Mauritius, Norway, Parkistan, Srilanka, and Thailand.

REVIEW QUESTIONS AND CASES

1. What is meant by "investment income"? Give five examples of income to be included for tax under the head "investment income".

2. Define the term dividend and indicate provisions of ITA 2002 that provide meaning of equivalent for dividend.

3. What are the incomes that are chargeable to income tax under the head investment? Discuss briefly.

4. What deductions are permissible in computing the income from investment? Explain.

5. What are the kinds retirement savings? Explain the important provision of each of them.

6. A natural person having source in Nepal disclosed the following particulars of his income and expenses for the previous year.

1. Rent income of computer from an individual person Rs. 36,000.
2. Net gain from disposal of depreciable assets Rs. 20,000.
3. Dividend income from a resident company (net) Rs 50,500.
4. Amount derived from winning from Bingo game (net) Rs 15,000.
5. Agriculture income received from Bhutan Rs 25,000.
6. Income derived from natural resources (net) Rs. 17,000.
7. Royalty income received from a publisher Rs. 10,000.
8. Interest income from domestic lending Rs. 150,000
9. Rent income received from part of the house rented to resident company Rs. 75,000.

The claim for deduction:

1. Collection charges of rents and dividend Rs 1,500
2. R&I costs of the computer Rs. 1,800
3. Depreciation of the computer Rs 1,200.
4. Donation to an exempt organization Rs. 15,000
5. Costs of Bingo game Rs. 1,000
6. Stationery expenses for natural resources Rs.500

7. Contribution to retirement fund for CIT Rs. 45,000.

Required:

(a) Assessable income

(b) Tax liabilities [6]

7. Mr. Ale presented the following particulars of his income and expenses for the previous year. Ascertain his tax liability for the relevant year. [6]

1. Remuneration received from articles writing in different newspaper Rs. 35,000.
2. Prize received from horse race after withholding Rs. 37,500.
3. Rent received from individual Rs. 50,000.
4. Net gain from disposal of shares after withholding Rs. 45,000.
5. Net gain received from disposal of domestic furniture, fixture and equipment Rs. 40,000.
6. Rent received from resident company (net) Rs. 45,000.
7. Investment income of his spouse Rs. 115,000.

8. Mr. Ale is also a contract teacher of TU. He received employment income Rs. 175,000 in previous year including occasional teaching salary from other campus Rs. 30,000.

He claimed the following amounts for deduction:

1. Stationery expenses for writing articles Rs. 3,000.
2. Horse related expenses including Rs. 13,000 prior year expenses Rs. 55,200.
3. Loss on disposal of private vehicles Rs. 5,000.
4. Collection charges of rent Rs. 900.
5. Costs of both teaching materials Rs. 17,500.
6. Investment amounts for CIT as a retirement fund Rs. 30,000.
7. Donation to an exempt entity Rs. 5,000.
8. Life insurance premium including husband and wife Rs. 18,000.
9. Medical expenses of Mr. Ale as per prescription Rs. 15,000.

9. Mr. Yakha Limbu is an auditor by profession has declared Rs. 150,000 as his professional income. Besides the above income he showed the following income.

1. Rent received from subletting Rs. 115,000. In a leisure period he also entertains as side work of subletting.
2. Gift received amounting Rs. 5,000 from his friend on the occasion of his marriage day.

3. Commission received Rs. 5,000 on account of business negotiation.
4. Interest income received Rs. 60,000 from Bhutan where the lending was made to individual. For this loan the interest rate of Bhutan was 50 percent lower than the interest rate of Nepal. If it was lending in Nepal the interest could be earned Rs. 120,000.
5. Net gain received from disposal of kitchen utensil Rs. 20,000
6. Money found in street during the previous year Rs. 5,000
7. Exchange gains from foreign currency accounts of US $ and GB pound were Rs. 15,000 and 7,500 respectively. But, amount from GB pound was not drawn yet.
8. Interest of lending which was made in Nepal to an individual was receivable Rs. 15,000.

Further information:

1. Rent received from Bhutan was net amount received after deducting traveling expenses of Rs. 2,000 and Rs. 5,000 for income tax.
2. Payment of commission for subletting Rs. 4,000.
3. The rent of subletting house was Rs. 70,000.
4. Commission on net gain from disposal of kitchen utensil was Rs. 800 but it was not paid yet.

Required:

(a) Assessable income

(b) Tax liabilities [3+3]

10. Mr. Tulachan, a residential person disclosed the following income for the previous year.

1. Net gain from disposal of residential house Rs. 595,000. It was sold before three years of its acquisition.
2. Commission from letting house of another person Rs. 15,000.
3. Earning from letting of computer was Rs. 50,000 including Rs. 5,000 as gift in this connection. But he has received only Rs. 25,000 at the end of the year.
4. Dividend Rs. 50,000 including 35,000 from non-resident company.
5. Interest from debenture from a listed Company Rs. 45,000

He claimed the following deduction:

Collection charge of all the incomes excluding net gain from disposal of residential house was Rs. 15,000 during the previous year.

Additional information obtained in the process of an investigation.

During previous year he purchased a motorbike on credit at Rs. 198,000. He paid Rs. 66,000 and remaining portion was remitted and paid by third person proportionately.

Required:

(a) Assessable income

(b) Statement of taxable income

(c) Tax liability [2+2+2=6]

11. Mr. Tuladhar furnished the following particulars of his income and expenses for the previous year.

1. Royalty of books received from a publisher after withholding tax Rs. 170,000 and gift received same publisher during the previous year was 60 grams of gold bracelet. The prevailing market price of gold was Rs. 15,000 per ten grams.
2. From holding a dollar account in foreign Bank received Rs. 25,000 as an excess amount at the time of account closing.
3. Bad debts recovered were Rs. 38,000 but the person adopts the cash basis accounting.
4. Amount received from jointly owned investment was Rs. 450,000 where Mr. Tuladhar portion of investment was 60%.
5. Amount received from letting a car Rs. 125,000.
6. Amount received were letting from a machine Rs. 60,000 and sub-letting a computer Rs. 36,000.

His expenses were:

1. Collection charges of royalty income and gift were Rs. 1,500 and Rs. 1,700 respectively.
2. Transportation charge to close dollar account was Rs, 3,000.
3. Brokerage charge to recover the bad debts was Rs. 1,000 (it was impossible without payment of broker charge)
4. The rent of sub-letting computer was Rs. 24,000.
5. The rent collection charge and cost of R&I of sub-letting computer was Rs. 1,500 and Rs. 3,000 respectively.

Required:

(a) Assessable income

(b) Tax liabilities [4+2]

12. Mr. Ghalan furnished the following statement of income about his income and expenses for the previous year.

Expenses	Amount	Income	Amount
Salary to assistants	260,000	Payment received from	
Collection costs	25,000	natural resources	255,000
Conveyance charges	400	Royalty from books	170,000

Rent	9,000	Interest income on FD	1,880
Donation to a club	35,000	House rent income	127,500
Purchase of equipment	250,000	Interest from domestic	
Depreciation	35,200	money lending activities	85,000
R&I cost of house	40,000	Equipment rent income	25,500
Net profit	10,280		
	664,880		664,880

Additional information:

1 Mr. Ghalan received investment income only however, he has furnished his income statement adopting accrual method of accounting.

2 All incomes except interest from domestic money lending were after withholding amounts.

3 Interest income Rs. 5,000 was receivable yet from domestic money lending activities.

4 Rent Rs. 2,000 was not paid yet.

Required:

(a) Assessable income

(b) Tax liabilities [4+2]

Chapter 12

Set Off, Carry Forward and Carry Back of Losses

ITA 2002 divides income into three heads: business, investment and employment. A loss can arise from the heads 'business income' and 'investment income' but loss can not arise from 'employment income'. A head may contain many sources of income. Similarly, a source may contain many incomes.

12.1 CONCEPT OF LOSS

Loss is a broad and qualified term. It is supposed to further qualify for an absolute meaning. In business, it means exceeding of expenses over income. It represents the condition in which a company's expenses over a given period are greater than its revenue over the same period; or where

its income from a particular transaction is less than the cost of transaction. In another words loss is ‘a failure to maintain original value, for example, in converting an investment to cash when less money received than originally put into it the investor has a negative return-on-investment’. So, losses symbolize decrease in economic benefits.

Loss may or may not arise in course of normal activities of business enterprise. It may also arise from natural disaster, fluctuation of exchange rate and disposal of non-current assets. Thus, the deductibility of loss depends upon certain circumstances.

In Nepal, losses are deductible. But, these are separated from provisions such as loss from business and investment and loss from domestic source and foreign source. The most common principle of loss from business for an income year may reduce any other income from other businesses and investment for same income year but it may not reduce for employment income. The losses of investment may only be offset from investment income. Similarly, this principle of set off losses also applies in foreign source for identical country only.

12.1.1 Concept of Carry Forward and Carry Back

Loss in one year used to reduce income in any/all of the next year is known as carry forward. Similarly, a technique for receiving a refund or back taxes by applying a deduction or credit from a current year to prior year is known as carry back. In short, a taxpayer may sometimes carry over deductions from income or profits or credits against tax which cannot be used in certain accounting year to subsequent years i.e., carry-forward or to previous years i.e., carry-back.

> **EXAMPLE 12-1** In an income year, a person incurred loss from his business. If it is permissible to make deduction from its business or investment income in later year/s, that method of carryover for deduction of loss is called carry forward of loss.

> **EXAMPLE 12-2** In an income year, a person incurred loss from his business. If it is permissible to make tax credit for the previously paid income tax, that is a carry back of loss.

12.1.2 Practices of Carry Forward and Carry Back

In most countries, an enterprise, which incurs a loss in one accounting year, may carry forward this loss to be offset against profits made in subsequent years. In many countries carry-forward is only allowed for a

limited period of time, but some countries allow an indefinite carry-forward of losses. In rare cases the setting-off of losses must be spread evenly over the next four or five years.

Carry-back of losses to be set off against profits made in previous years is allowed in few countries and is usually restricted to one or two years. Sometimes carry-back is restricted to a certain amount. Credits granted against tax, such as foreign tax credits, investment credits, jobs credits, etc. may sometimes be carried over if they cannot be used in the year of tax credit.

12.2 OFFSET OF LOSSES AND DURATION FOR OFFSET

Offset of losses depends on loss from active and passive or recurring and non-recurring nature of income. In Nepal, active or recurring nature of income is business or employment income while passive or non-recurring nature of income is investment income. But, losses are never offset from employment income.

Table 12.1: Carry-forward and carry back of losses

Section	Nature of losses	No of years for which loss can be carried forward and carried back
Neither carry forward nor carry back		
§20(2)	Investment loss (revenue nature)	Same income year
Carry forward of losses		
§20(1)	Loss of ordinary business	Following four income years
§20(1b)	Loss from build, operate and transfer to public and infrastructure business	Following seven income years
§20(1b)	Loss from petroleum business	Following twelve income years
Carry forward with carry back of losses		
§59(2) and 60(3)	Loss from banking and general insurance businesses	Carry back five preceding income years and carry forward following four income years
§20(4)	Loss from long-term contract (contract obtained through international competition)	Unrelieved loss available to carry forward: the department may, by notice in writing , allows the loss to be carried back to a preceding income year or years

12.2.1 Offset in the Same Income Year

Any unrelieved losses from 'investment' [§20(2)] can recover from other investment during the year. The losses of the investment must not be carried forward for the future income year. Therefore, if a person suffers a loss from investment and cannot use it in the year it is incurred, the taxpayer can not carry that loss forward.

If loss is incurred in business asset, this can be set-off from gain on the disposal of business or/and non-business chargeable asset. But, if loss is incurred in non-business chargeable asset, it can only be set-off against gain on the disposal of non-business chargeable asset.

12.2.2 Offset with Carry Forward

Duration of carry forward of loss varies from four income years to twelve income years. Specially, the duration of offset depends on nature of business.

12.2.3 Unrelieved loss of Ordinary Business [§20(1)]

Any unrelieved loss of business may be carried forward to reduce income from any business or investment to the following four income years. This means that a carry-forward is provided for ordinary business losses and that the carry forward is usually limited to four years. The loss if not recovered within the following four income years is observed for unrelieved forever.

> **EXAMPLE 12-3** A business incurred unrelieved loss Rs. 400,000 in an income year. It can reduce till the following four income years. The loss of that income year if not recovered up to the following four income years that are unrelieved forever.

12.2.4 Unrelieved Loss from Build, Operate and Transfer to Public and Infrastructure Business [§20(1b)]

Special provisions are made for electricity projects and projects that build, operate and transfer to public and infrastructure businesses or projects. Under this provision, the time to carry forward losses is extended to seven years.

12.2.5 Unrelieved Loss from Petroleum Business [§20(1b)]

Special provisions exist for conducting petroleum transaction and having registered according to Petroleum Act 2040. The time to carry forward losses is extended to twelve years for these businesses.

12.2.6 Offset with Carry Back and Carry Forward

Some businesses are additionally benefited by the carry back of losses. When both offsets are facilitated to the businesses the treatment of carry back is applied first.

12.2.7 Unrelieved Loss from Long-Term Contract [§20(4)]

In case of long-term contract obtained through international competition, when a person incurs any loss, or has an unrelieved loss available to carry forward, the department may, by notice in writing , allows the loss to be carried back to a preceding income year or years, and treated as an unrelieved loss incurred during that year or years in relation to a long term contract up to an amount not exceeding the excess amount included in calculating the income from the business after deducting the amount included in expenses.

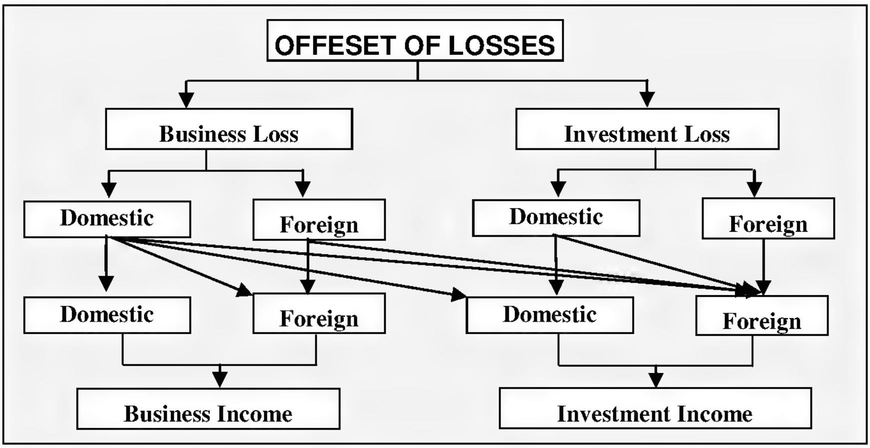
12.2.8 Unrelieved Loss from Banking and General Insurance Businesses [§59(2) and 60(3)]

In addition, banking and general insurance businesses are not only allowed to carry forward their losses but may also carry them back and deduct from their business income for any of the five preceding tax years.

12.3 OFFSET OF LOSSES

Offset of losses may be offset by inter-source, inter-head and inter-country. But, there is not provided offset option for all sources and heads. Option of offset between sources and heads is shown in the following figure 12.1.

Figure 12.1: Offset of losses



12.3.1 Inter-Source Adjustment

As a general rule, when there is a loss from one source it could be set off against losses from other sources under the same head in the same assessment year. This is known as inter-source adjustment.

12.3.2 Inter-Head Adjustment

Where, after such set off, the net result of computation under any head of income in respect of an accounting year is a loss, such amount of loss can be set off against the income assessable for that assessment year under any other head. This is known as inter-head adjustment.

12.3.3 Losses from Foreign Source [§20(3)]

A person may deduct an unrelieved loss incurred in relation to a foreign source only in calculating the person's foreign source income and an unrelieved loss incurred in deriving non-taxable income only in calculating the person's non-taxable income.

> **EXAMPLE 12-4** A person operates business and investment activities in Nepal, Philippines, and North Korea. In an income year, he earned business profits from Nepal. But, in the same income year he incurred business loss from Philippines and investment loss from North Korea. Under this situation, he cannot deduct that unrelieved loss of Philippines and North Korea from taxable income of Nepal.
>
> To deduct the unrelieved loss of business of Philippines he must have another business or investment income from Philippines. Similarly, to deduct the unrelieved loss of North Korea he must have another investment income from North Korea.

12.3.4 Fundamental Rules for Offsetting

The term offset indicates something that counterbalances or compensates, or an allowance made in order to counterbalance something. Thus, offset of losses are made among sources and between heads of income in Nepal. The offsetting provision of losses among sources and heads are presented in the following table.

Table 12.2: Offset of losses

<table>
<tr><td colspan="2">1. Domestic sources</td></tr>
<tr><td colspan="2">Income from business of domestic sources may be reduced by [§20(1)]</td></tr>
<tr><td rowspan="3">Domestic losses from other business</td><td>(a) Of the current income year, and</td></tr>
<tr><td>(b) Of the previous four income years</td></tr>
<tr><td>But, not domestic losses from investments and foreign losses from business and investment.</td></tr>
</table>

<table>
<tr><td colspan="2">Domestic income from investment may be reduced by [§20(1) & 20(2)]</td></tr>
<tr><td rowspan="4">Domestic losses from other</td><td>(a) Businesses of the current income year</td></tr>
<tr><td>(b) Businesses of the previous four income years</td></tr>
<tr><td>(c) Investments of the current income year.</td></tr>
<tr><td>But, not foreign losses from business or investment.</td></tr>
</table>

<table>
<tr><td colspan="2">2. Foreign sources</td></tr>
<tr><td colspan="2">Foreign income from business may be reduced by [§20(3)]</td></tr>
<tr><td rowspan="3">Foreign losses from other businesses of the same country and domestic losses of the other business</td><td>(a) Of the current income year</td></tr>
<tr><td>(b) Of the previous four income years</td></tr>
<tr><td>But, not domestic losses from investments</td></tr>
<tr><td colspan="2">Foreign income from investment may be reduced by</td></tr>
<tr><td rowspan="4">Foreign losses from other</td><td>(a) Businesses of the current income year</td></tr>
<tr><td>(b) Businesses of the previous four income years</td></tr>
<tr><td>(c) Foreign losses from other investments</td></tr>
<tr><td>But, not foreign losses from business or investment of the other countries of the person</td></tr>
</table>

12.3.5 Income from a Domestic Business

A person's income from a domestic business may be reduced by losses from the person's other domestic business. However, the person cannot deduct losses from domestic investments and losses from foreign business or investment.

> **EXAMPLE 12-5** A person operates two businesses: furniture production and grill production. In an income year, the person earns profit from grill and incurs loss from furniture. In this context, the incurred loss from furniture production can reduce from the income of grill production.

> **EXAMPLE 12-6** In an income year, a person receives income from business and loss from investment income. In this situation, the loss from investment can not reduce from business income.

Income from a domestic investment may be reduced by the losses of the domestic business and other domestic investments while the income from a domestic investment income may not be reduced by the business and investment losses of foreign sources.

CASES AND SOLUTIONS

Loss in ordinary business

1. A Ltd. Company made profit for two years after incurring losses for five consecutive years as given below:

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Profit/ Loss	(30,000)	(60,000)	(20,000)	(14,000)	(20,000)	90,000	75,000

Additional Information:

The above submitted figures of profit and loss account of the company are after deduction of donation amounts as per assessment. The deductions of donation amount are Rs. 15,000 in the year one and Rs. 2,000 in year six.

Required:

Taxable income giving explanation wherever necessary [4+2]

Solution:

Set off, carry forward and recovery position of loss for the years 1-7

Year		**1**	**2**	**3**	**4**	**5**	**6**	**7**
Profit/loss		(30,000)	(60,000)	(20,000)	(14,000)	(20,000)	90,000	75,000
Non-ded. amt.		15,000					2,000	
Computed P/L		(15,000)	(60,000)	(20,000)	(14,000)	(20,000)	92,000	75,000
Loss carry forward and recovery position:								
In the year	For the year							
6	2						(60,000)	
6	3						(20,000)	
6	4						(12,000)	
7	4							(2,000)
	5							(20,000)
Irrecoverable		(15,000)						
Taxable income		-	-	-	-	-	-	53,000

Clarification:

1. Donation is not business expense. Specially, it is donated when a person earns profit. ITA 2002 exempts that donation given to tax exempt entity not more than five percent of the adjusted taxable income or Rs. 100,000. Thus, donations are non-deductible while a person incurs loss.
2. Loss of the year first is irrecoverable due to its time limitation.
3. It earns taxation income of Rs. 53,000 in the year seven.

Intra-Head Adjustment

2. The following are the income or losses from business and investment before loss adjustment of an Entity during last 5 years.

Heads / years	1	2	3	4	5
Business	10,000	(5,000)	(80,000)	30,000	60,000
Investment	(5,000)	10,000	20,000	5,000	(5,000)

Required:

(a) Taxable income

(b) Explain unrelieved loss and intra-head adjustment [4+2]

Solution:

Statement of loss set off; carry forward, recovery and taxable income for the years one to five.

Heads / Years		1	2	3	4	5
Business		10,000	(5,000)	(80,000)	30,000	60,000
Investment		(5,000)	10,000	20,000	5,000	(5,000)
Unrelieved business loss		-	5,000	20,000	-	
Loss set off				(60,000)		
Loss carry forward and recovery position:						
in the year	for the year					
4	3				(35,000)	
5	3					(25,000)
Taxable income		10,000	5,000	-	-	35,000
Unrelieved loss forever:						
Business		-	-	-	-	-
Investment		(5,000)	-	-	-	(5,000)

Clarification:

1. Loss of investment of the year one and five can not be offset from business income since loss from investment is not subject to intra-head adjustment.
2. Loss from business can setoff for intra-head and intra-source adjustment. Thus, adjustment of unrelieved losses of the year two and three are adjusted from investment income.

3. An entity made the following operating results for the seven years:

Year	1	2	3	4	5	6	7
Business P/L	(150,000)	(25,000)	10,000	(20,000)	15,000	30,000	125,000
Investment P/L	2,000	4,000	10,000	4,000	(5,000)	4,000	(6,000)

Additional information:

In the year one, a donation was given to a public school of Rs. 10,000 and in the year two, a life insurance premium paid on the policy of executive director of Rs. 5,000 before determining the stated profit/losses.

Required:

(a) Taxable income

(b) Make a statement of explanation where necessary [4+2]

Solution:

Statement of loss set off; carry forward, recovery and taxable income for the years one-seven

Heads/Years	1	2	3	4	5	6	7
Business	(150,000)	(25,000)	10,000	(20,000)	15,000	30,000	125,000
Investment	2,000	4,000	10,000	4,000	(5,000)	4,000	(6,000)
Non-deductible amt.	10,000	5,000	×	×	×	×	×
Business loss relieved	2,000					×	
Loss set off	(138,000)	(20,000)		(20,000)			
Loss carry forward and recovery position:							
In the year	For the year						
2	1	(4,000)					
3	1		(20,000)				
4	1			(4,000)			
5	1				(15,000)		
6	2					(20,000)	
6	4					(14,000)	
7	4						(6,000)
Taxable income	×	×	×	×	×	×	119,000
Unrelieved loss forever:							
Business	(95,000)	×	×	×	×	×	×
Investment	-	-	-	-	(5,000)	-	(6,000)

Clarification:

Investment loss of the year five and seven can not be adjusted from business income for reason that loss from investment is not subject to intra-head adjustment. Loss from business can be setoff in intra-head and intra-source adjustment. Thus, adjustment of unrelieved loss of the business is adjusted from investment income.

Intra-Source and Intra-Country Adjustment

4. Mr. Mahato has run two businesses in Nepal and Bhutan. Operating results of the businesses during the last six years are as follows:

Year	Countries	1	2	3	4	5	6
Profit or Loss	Nepal	(40,000)	2,000	25,000	15,000	90,000	10,000
	Bhutan	50,000	(90,000)	2,000	25,000	9,000	55,000

Required:

Compute taxable income giving explanation wherever necessary.[4+2]

Solution:

Statement of set off, carry forward and recovery position of loss for the years one-seven

Year		1	2	3	4	5	6
Nepal		(40,000)	2,000	25,000	15,000	90,000	10,000
Adjusted from foreign source		50,000					
Profit/loss on domestic source		10,000	2,000	25,000	15,000	90,000	10,000
Bhutan		-	(90,000)	2,000	25,000	9,000	55,000
Loss carry forward and recovery position:							
in the year	for the year						
3	2			(2,000)			
4	2				(25,000)		
5	2					(9,000)	
6	2						(54,000)
Taxable income:							
Foreign source		-	-	-	-	-	1,000
Domestic source		10,000	2,000	25,000	15,000	90,000	11,000

Clarification:

1. Loss of domestic source can be recovered by the foreign source while loss of foreign source can not be recovered by the domestic sources.
2. On the basis of loss from business and investment respectively, a person may deduct an unrelieved loss incurred in relation to a foreign source only in calculating the person's foreign source income.

Intra-Source, Intra-Head and Intra-Country Adjustment

5. The following are operating results of a business and investment operated in Nepal and Hungary for the two income year of Mr. Karanjit.

Countries	**Income heads**	**Year**	
		1	2
Nepal (domestic source)	Business	(50,000)	30,000
	Investment	(15,000)	30,000
Hungary (foreign source)	Business	(15,000)	10,000
	Investment	40,000	(20,000)

Required:

Taxable income from domestic and foreign source giving explanation wherever necessary [4+2]

Solution:

Statement of set off, carry forward and recovery position of loss for the years 1-7

Year	**Year 1**			**Year 2**		
Heads	**Business**	**Investment**	**Total**	**Business**	**Investment**	**Total**
Domestic source						
Nepal	(50,000)	(15,000)	(65,000)	30,000	30,000	60,000
Loss set-off	(50,000)	-	(50,000)	-	-	-
Taxable income						60,000
Foreign source						
Hungary	(15,000)	40,000	25,000	10,000	(20,000)	10,000
Set off loss	(15,000)	-	-	-	-	-
Taxable income			25,000	10,000		10,000
Loss recovered						
Domestic:						
Domestic losses of the year 1 by the						
foreign income of year 1				(25,000)		
Domestic losses of year 1 by the						
domestic income of year 2						(25,000)
Taxable income (1) Domestic [Nepal]						35,000
(2) Foreign [Hungary]						10,000

Clarification:

1. Foreign income from business may be reduced by foreign losses from other businesses - of the current income year and of the previous four income years (not: domestic losses from investments)
2. Foreign income from investment may be reduced by foreign losses from other businesses - of the current income year, previous four income years and foreign losses from other investments (not: foreign losses from business or investment of other countries)

Carry Back and Carry Forward of Losses

6. The following are the operating results in million rupees of Nepal National Commercial Bank Limited (NNCBL) for 11 years.

year	1	2	3	4	5	6	7	8	9	10	11
P/L	150	250	350	450	100	(2,000)	50	100	150	200	1,400
T/R	35	35	30	27.5	25	30	30	25	30	30	30

Required:

Taxable income giving explanation wherever necessary [4+2]

Solution:

Statement of set off, carry back and carry forward and recovery position of loss for the years one-eleven years.

Years	Profit and loss	Loss recovered	Balance to be recovered	Tax rate	Tax credit	Balance of tax credit	Tax payable
1	150			35	52.5	52.5	-
2	250			35	87.5	140	-
3	350			30	105	245	-
4	450			27.5	123.75	368.75	-
5	100			25	25	393.75	-
6	(2,000)		(2,000)	30	-	-	-
Recovery position							
By carried back		(1,300)					
By carry forward			(700)				
7	50	(50)	(650)	30	-	393.75	-
8	100	(100)	(550)	25	-	393.75	-
9	150	(150)	(400)	30	-	393.75	-
10	200	(200)	(200)	30	-	393.75	-
11	1400	-	-	30	-	-	420
Unrelieved loss forever			(200)				
Tax payable							[420-393.75] =26.25

Clarification:

1. Banking and general insurance businesses may carry back losses for five year before the carry forward applies, i.e. they may reduce their taxable income or incomes of the previous years and deduct the loss from them before they carry forward the loss to future income years.
2. Unrelieved loss forever and tax payable stood Rs. 200 and Rs. 26.25 after adjustment respectively.

Tax Loss Carry Back and Carry Forward Outside Nepal

7. The following are the operating results in million rupees of a Commercial Bank Limited for the 10 years.

Years	1	2	3	4	5	6	7	8
Taxable income	7,100	5,750	18,450	10,200	25,800	(90,800)	16,500	6,000
Tax paid	2,069	1,866	4,771	3,534	8,874	0	0	2,500

Additional information:

1. The tax rate for the year six, seven, and eight is 30%.
2. Tax amount of the year eight is the amount of advance tax.

Required:

Tax liability or tax credit of the eighth year giving explanation [5+1]

Solution:

[Many countries apply this method of tax loss carry back and carry forward]

Statement of set off, carry back, carry forward and recovery position of tax loss for the years one-eight.

Years	Profit and loss	Tax loss recovered	Balance to be recovered	Tax rate	Tax credit	Balance of tax credit	Tax payable
1	7,100				2,069	2,069	-
2	5,750				1,866	3,935	-
3	18,450				4,771	8,706	-
4	10,200				3,534	12,240	-
5	25,800				8,874	21,114	-
6	(90,800)		(27,240)	30	-	-	-
Recovery position: By carry back			(6,126)				
By carry forward		21,114					
7	16,500	(4,950)	(1,176)	30	-		-
8	6,000	(1,176)	-	30	2,500		624
Tax credit						1,876	

Clarification:

Banking and general insurance businesses may carry back losses for five year before the carry forward applies, i.e. they may reduce their taxable income or incomes of previous years and deduct the loss from them before they carry forward the loss to future income years.

REVIEW QUESTIONS AND CASES

1. What the provisions are of set-off of business loss? How are they carried forward? Explain.
2. How does an investment loss differ from business loss in the matter of set-off and carry forward of losses? Explain fully.
3. What provisions govern the set-off loses for banking and insurance business. How are they carried back? Explain.
4. An entity furnishes the following operating results for the next 7 years:

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Profit (loss) Rs	(150,000)	75,000	(60,000)	20,000	(25,000)	30,000	25,000

In the year two, a donation of Rs. 5,000 was given to a public school and in the year three, it includes dividend income of Rs. 5,000.

Required:

Taxable income giving explanation where necessary [3+3]

5. An individual person furnishes the following results of income statement for the next seven years including both investment and business income.

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Profit (loss) Rs	(170,000)	35,000	(90,000)	40,000	(35,000)	60,000	55,000

Additional information:

(a) Loss of the year one includes donation Rs. 5,000 and loss from investment Rs. 25,000.

(b) In the year two, the profit arrived after deduction of investment loss Rs. 15,000.

(c) In the year six, the profit derived after deduction of donation Rs. 9,000.

(d) The results of the remaining year are the result from business income.

Required:

Taxable income giving explanation where necessary [4+2]

6. The operating results of a Company for the past seven years were given below.

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Profit (loss)Rs.	60,000	20,000	20,000	30,000	40,000	20,000	50,000

In the year five the company donated Rs. 70,000 to Pashupati Area Development Trust (PADT) and this figure was charged to Company's income statement of this year.

Required:

Taxable amount of the company for the above periods giving appropriate appending notes [4+2] [MBA 2055, TU, modified]

7. A Ltd. company anticipates the following operating results for the next seven years:

Year	1	2	3	4	5	6	7
Profit (loss) Rs.	50,000	25,000	10,000	20,000	15,000	30,000	25,000

In the year one, a donation of Rs. 10,000 given to a public school and in the year two, Life insurance premium Rs. 5,000 paid on the policy of Executive Director was charged before determining the aforesaid losses.

Required:

Taxable income of the company giving explanation wherever necessary [3+3] [MBS 2059, TU, modified]

8. A Banking Ltd. Company anticipates the following operating results for the next 8 years:

Years	1	2	3	4	5	6	7	8
Profit (loss)	90,000	90,000	75,000	80,000	70,000	95,000	(630,000)	225,000
Tax rates	35	33	33	31	30	30	30	30

The results of the year six and the year eight are derived after deduction of donation Rs. 5,000 each.

Required:

Taxable income giving explanation where necessary [3+3]

9. A Banking Ltd. Company anticipates the following operating results for the next eight years:

Years	1	2	3	4	5	6	7	8
Profit (loss)	9,000	(90,000)	15,000	(80,000)	70,000	95,000	250,000	(325,000)
Tax rates	35	33	33	31	30	30	30	30

The results of the year two and four are derived after including loss from investment Rs. 5,000 each.

Required:

Balance to be recovered giving appropriate explanation [3+3]

10. The following results are taken from a build, operate and transfer to public and infrastructure business.

Years	1	2	3	4	5	6	7	8	9
Profit (loss)	(3,500)	400	200	250	275	350	(600)	(150)	1,500

Required:

Taxable income and appropriate reason for unrelieved loss forever [3+3]

Chapter 13

Deductions from Assessable Income

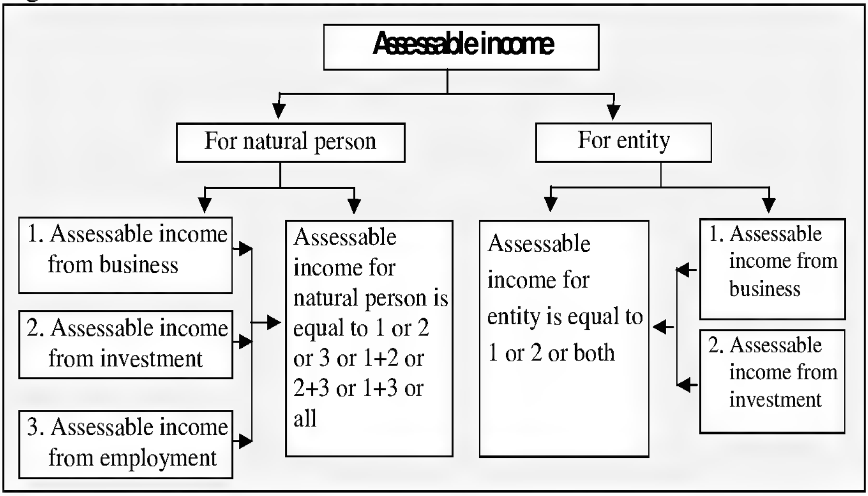
13.1 ASSESSABLE INCOME

Usually assessable income means computable amount of money received over a period of time either as payment for work, goods, or services, or as profit on capital. Thus, assessable income is the amount of taxable or chargeable income (what any person is taxed on). It may be used in different places in taxation with different purposeful meaning.

Assessable income is calculated from each income head. Person residing in Nepal is taxable with their global income irrespective of location of its source. It means that an individual residing in Nepal in addition to a

partnership, company, corporation, trust or foreign branch located in Nepal is taxable for total sources of income that this person has earned irrespective of the country where the earning activity are done from business or investment.

Figure 13.1: Calculation of assessable income



Similarly income of a non-resident person from employment, business or investment of the year is taxed but only to the extent income has a source in Nepal.

13.2 DEDUCTIONS FROM ASSESSABLE INCOME

There are only two broad deductions from assessable income: contribution to retirement fund and donation amounts.

13.2.1 Contribution to Retirement Fund (CRF)

A scheme of contribution to retirement fund (CRF) is a social measure. It also encourages savings. Under the scheme, a specific amount is deducted from the salary of an employee every month which is credited to his account in the CRF. The employer is also appreciated to contribute a specific amount every month to the credit of his personal account in the investment fund from the income of employment. Thus, retirement contributions are payments of an individual made to a retirement fund for the provision or future provision of retirement payments. According to §63(3) individuals can deduct their retirement contributions made to an approved retirement fund from their assessable income up to a limit of rupees Rs. 3,00,000 or one third of assessable income, whichever is

lower for each income year. However, contributions of an individual to an unapproved retirement fund are not deductible from their assessable/taxable income.

EXAMPLE 13-1 A Chief Secretary of the Government of Nepal (GoN) draws salary Rs. 19,500 per month including grade. He receives 13 months salary including Dashain allowance. If he is a member of approved retirement fund (ARF), has to deduct for retirement fund at least 10 percent of his salary in the government service.

EXAMPLE 13-2 Assume that same case of the **EXAMPLE 13-1**, if he also made an additional investment fund in Citizen Investment Trust (CIT) by 5 percent of the assessable income. In this situation, total contribution to retirement fund is calculated as given below:

Calculation of deductible retirement fund			**Amount**
Salary including grade and Dashain allowance			253,500
Add:	CRF (by employer)		23,400
Assessable income			276,900
	CRF (by both)	46,800	60,645
	Investment fund for CIT	13,845	
	Or, 1/3 of assessable income (1/3×276,900)		92,300
	Or, Rs. 300,000		300,000
Thus, deductible amount of CRF equals to Rs. 60,645			60,645

EXAMPLE 13.2 A General Manager of a bank draws monthly salary Rs. 450,000. He contributes 10 percent of the salary for ARF and his employer also contributes equal amount. His reduction of retirement contribution from assessable income is equal as:

Calculation of deductible retirement fund		**Amount**
Salary (Rs. 450,000×12)		5,400,000
Add:	CRF (by employer)	540,000
Assessable income		5,940,000
	CRF (by both) [Rs. 540,000×2]	1,080,000
	Or, 1/3 of the assessable income (1/3×5,940,000)	1,980,000
	Or, Rs. 300,000	300,000
Thus, deductible amount of CRF equals to Rs. 300,000.		300,000

Thus, reduction for the contribution to retirement fund is Rs. 300,000 from assessable income.

EXAMPLE 13.3 A proprietor of Sole Trading Concern and employee of a NGO furnishes his assessable income Rs. 150,000. In retirement fund, the NGO contributes Rs. 11,000 and similar amount is also contributed by the employee. He contributes in CIT Rs. 30,000. In this situation, his CRF is calculated as given below:

Calculation of retirement fund			**Amount**
Assessable income			150,000
	CRF (by both)	22,000	52,000
	Investment fund on CIT	30,000	
	Or, 1/3 of the assessable income (1/3 ×150,000)		50,000
	Or, Rs. 300,000		300,000
Thus, deductible amount of CRF equals to Rs. 50,000			50,000

Thus, deduction for the CRF becomes one third of assessable income.

13.2.2 Gifts to Exempt Organization

Gifts [§2(j)] are payments without consideration or with consideration only to the extent the market value of payments exceed the market value of consideration. Those gifts or donations have a character that is different from that of general or special deductions. Gifts or donations are deducted from assessable income and not the income from one of three heads: business, investment or employment and on the basis of adjusted taxable income to arrive at taxable income.

Gifts have no role in producing income. Thus, gifts to tax exempt organizations are deducted on the provision of statutory basis. In addition, gifts to tax exempt organizations are also limited by the provision. Apart from these limitations, The Government of Nepal may prescribe by notification in the Nepal Gazette for special donations for special purposes that are deductible whether partial or in full.

Deduction of gifts §12(2) from taxable income is limited to Rs. 100,000 or 5 percent of the person's adjusted taxable income for the income year whereas adjusted taxable income is computed without a reduction for gifts, PC and R&D costs. The calculation scheme to decide limitation of gift amount is presented below.

Table 13.1: Calculation of limit for deduction of gifts to tax exempt organizations

Calculation of donation and gifts		**Amount**
Equals	Assessable income [Assessable income from investment, assessable	Rs_×

	income from business before deduction of PC costs, R&D cost and interest (Paid to tax exempt controlled entity) and assessable income from employment (in case of natural person)]	
Less	CRF [in case of natural person]	Rs__×
Adjusted taxable income		Rs__×
	5% of the adjusted taxable income	Rs__×
	Or Rs. 100,000	Rs__×
	Or Gifted amount	Rs__×
Thus, deductible amount equals to lower among the three.		Rs__×

EXAMPLE 13.4 In a year, a natural person furnished Rs. 500,000 assessable income calculating both heads: employment and investment. He is a member of ARF and contributes 10 percent of the salary and his employer contributes an equal amount. His salary including grade was Rs. 250,000 per annum. He gifted 16,000 rupees to an exempt entity. In this position, deductible amount of gift is ascertained as given below:

Calculation of deductible gift:		**Amount**
Equals	Assessable income	500,000
Less	CRF	50,000
Adjusted taxable income		450,000
	5% of the adjusted taxable income	22,500
	Or, Rs. 100,000	100,000
	Or, gifted amount	16,000
Thus, deductible gift amount equals to Rs. 16,000		16,000

EXAMPLE 13.5 In an income year, an entity furnished an adjusted taxable income — before deduction of gift, interest (paid to exempt controlled entity) R&D and PC costs — Rs. 4,500,000. It gifted Rs. 625,000 to an exempt entity. For this case, deduction of gift amount is ascertained as given below:

Calculation of deductible gift		**Amounts**
Equals	Adjusted taxable income	4,500,000
	5% of adjusted taxable income	225,000
	Or, Rs. 100,000	100,000
	Or, gifted amount	625,000
Thus, deductible donation equals Rs. 100,000.		100,000

As a result, the allowable deduction of donation for the income year becomes Rs. 100,000.

EXAMPLE 13.6 In an income year, a natural person furnished assessable income including two heads: investment and business Rs. 6,500,000. Assessable income was after deduction of PC cost of Rs. 50,000. He has also invested in CIT Rs. 500,000 as retirement fund himself. It has gifted Rs. 85,000 to an exempt entity. In this position, the amount of gift is determined as given below:

Calculation of donation and gifts		**Amount**
Equals	Assessable income	6,500,000
Add:	Cost of PC	50,000
Less	CRF [not more than 1/3 of the assessable income or Rs. 300,000]	(300,000)
Adjusted taxable income		6,250,000
	5% of the adjusted taxable income	312,500
	Or, Rs. 100,000	100,000
	Or, gifted amount	85,000
Thus, deduction of gift amount is Rs. 85,000.		85,000

Consequently, the allowable charitable deduction for the income year becomes Rs. 85,000.

In addition, gifted amounts are not permitted before deduction of loss, if exists any.

☐ Other Consideration in Relation to Gift Amount

Both individual and entity may deduct charitable contributions if the recipient is a qualified charitable organization. Generally, a deduction will be allowed only for the year in which the payment is made. There are some exceptional cases which apply to donors; however, the law expresses nothing.

☐ Provision for Gift

Provision of gift in accounting books can not be eligible as gift. The gift or donation is accounted for tax purposes only when it is handed over from donor. Remission of the gift is qualified by the submission of endowment evidence.

EXAMPLE 13-7 A person made a provision of gift in an income year to give it in the following year. If he claimed to deduct it in the income year, that can not be deducted. It may be deducted in the following year if it is really gifted.

☐ Property Contribution

The amount that can be deducted for non-cash charitable contribution depends on the type of capital or property contributed. Property must be identified as long-term capital gain property or ordinary income property. Long-term capital gain property is property that, if sold, would result in long-term capital gain for the person (donor). Such property generally must be a capital asset and must be held for long-term holding period more than 12 months. Ordinary income property is the property, if sold, would result in ordinary income for the person (donor).

The deduction for a charitable contribution of long-term capital gain property is generally measured by prevailing market value.

EXAMPLE 13-8 In an income year, a Company donates a piece of land (a capital asset) to an exempt entity. It was acquired by the company two years ago for Rs. 60,000 and the prevailing market value on the date of contribution is Rs. 100,000. The Company's contribution deduction (subject to a percentage with limitation) is measured by the asset's prevailing market value Rs. 100,000 and Rs. 40,000 appreciation on the land value has to be included in income as net gain from transfer of the land.

There are two types of donations practiced in Nepal. The first type of donation is limited by the percentage and amount of ceiling and the next type can be prescribed by the government notifying in Gazette.

EXAMPLE 13-9 A person pays both types of donations: Club and Prime Minister Relief Fund. Assume that the donation amounts were Rs. 15,000 and Rs. 150,000 respectively. In the year, the person's adjusted taxable income was Rs. 140,000. In this context, the donation amount is calculated as given below:

Calculation of deductible gift		**Amounts**
Equals	Adjusted taxable income	140,000
	5% of the adjusted taxable income	7,000
	Or, Rs. 100,000	100,000
	Or, gifted amount	15,000
On percent	Deduction of gift amount (for club)	7,000
Prescribed	Donation to Prime Minister Relief Fund	140,000
Total of donation amount		147,000

According to law, donation to a club or Prime Minister Relief Fund may deduct from assessable income. But, the loss arising from donation such as Rs. 7,000 cannot deduct for set off, carry forward and carry back.

CASES AND SOLUTIONS

1. An Entity disclosed the following particulars. Calculate taxable income of the Entity.

1. Assessable income from business — after deduction of PC cost and R&D costs Rs. 150,000 and Rs. 200,000 respectively — Rs. 1,460,000.
2. Assessable income from investment Rs. 100,000
3. Donations:
   (a) Football Club (exempt) Rs. 120,000
   (b) Pashupati Development Trust (PDT) Rs. 650,000

Solution:

Calculation of taxable income of an Entity for the income year ....

S.No.	Particulars	Amount	Amount
1	Assessable income from business	1,460,000	
2	Assessable income from investment	100,000	1,560,000
Assessable income			1,560,000
DEDUCTION FROM ASSESSABLE INCOME			
DONATIONS OR GIFTS:			
1	Football Club [5% of the Rs. 1,910,000]	95,500	
2	PDT [If prescribed in the Gazette]	650,000	
Total deduction from assessable income		745,500	745,500
Taxable income			814,500

Working note:

1. Calculation of adjusted taxable income

Assessable income from business			1,460,000
Add: Reduced costs			
1	PC costs	150,000	
2	R&D costs	200,000	350,000
Business income before deduction of PC and R&D costs			1,810,000
Add:	Assessable income from investment		100,000
Adjusted taxable income			1,910,000

2. Calculation of deductible donation amount paid to Football Club.

(a) Donation paid to Football Club is calculated not more than 5 percent of the adjusted taxable income or Rs. 100,000.

(b) Donation paid to PDT is deducted after deduction of donation to Football Club.

(c) Donation paid to PDT is prescribed donation thus, it does not fall under the rule of not exceeding 5 percent of the adjusted taxable income or Rs. 100,000.

Adjusted taxable income			1,910,000
1	5% of the adjusted taxable income	95,500	
2	Or Rs.	100,000	
3	Or donated amount	120,000	
Thus, deductible donation amount should be:			95,500

2. An Individual presented the following particulars about his income for an income year. Find out taxable income of the individual.

1. Assessable income from business Rs. 4,050,000.
2. R&D and PC costs were Rs. 350,000 and Rs. 400,000 respectively.
3. Assessable income from investment is Rs. 650,000.
4. Assessable income from employment is Rs. 350,000.
5. The individual is a member of ARF. For the CRF, both employer and employee contribute Rs. 30,000 each. In addition, the individual also makes an investment in CIT of Rs. 280,000.
6. Donations made:
   (a) Teacher's Association (exempt) Rs. 15,000
   (b) Lumbini Development Trust (LDT) Rs. 1,000,000.

Solution:

Calculation of taxable income of an Individual for the income year ....

STATEMENT OF ASSESSABLE INCOME			Amount	Amount
1	Assessable income from business		4,050,000	
2	Assessable income from investment		650,000	
3	Assessable income from employment		350,000	
Assessable income			5,050,000	5,050,000
DEDUCTION FROM ASSESSABLE INCOME				
1	CRF (Rs.30,000x2)	60,000	300,000	
2	Investment in CIT	280,000		
3	Donation: (a) Teacher's Association		15,000	
4	(b) LDT[1]		1,000,000	
Total deduction from assessable income			1,315,000	1,315,000
Taxable income				3,735,000

[1] Finance Act 2063 has not made any provisions of prescribed donations to LDF, PDT, P.M. Relief Fund etc. Thus, the case regards only for practice.

Working Note:

1. **Calculation of contribution to retirement fund**

   CRF is calculated not exceeding one third of assessable income or Rs. 300,000. Thus, if there occurs multi-types of contributions, the calculation has to be made for one third or Rs. 300,000 as a lump sum not indicating any one as given.

Assessable income			5,050,000
1	One third of assessable income	1,683,333	
2	Or Rs.	300,000	
3	Or contributed amount	340,000	
Deductible amount of CRF including investment of CIT			300,000

2. **Calculation of adjusted taxable income (for donation purposes)**

Assessable income from business			4,050,000
Add:	**Reduced costs**:		
1	PC costs	400,000	
2	R&D costs	350,000	
Total amount of reduced		750,000	750,000
Adjusted taxable income (PC/R&D purposes)			4,800,000
Add:	Assessable income from investment		650,000
	Assessable income from employment		350,000
Adjusted taxable income before deduction of CRF			5,800,000
Less:	CRF		300,000
Adjusted taxable income (for donation purposes)			5,500,000

4. Mr. Ali furnished the following particulars for the previous year.

1. Assessable income from employment Rs. 115,000
2. Assessable income from business Rs. 185,000
3. Assessable income from investment Rs. 150,000

He claims the following deductions:

1. Rs. 200,000 for CRF
2. Donation to Bir Hospital Rs. 25,000

Required:

Tax liability of Mr. Ali [5]

Solution:

Calculation of Assessable Income and Tax Liability of Mr. Ali for the Income Year 2063/064

1	Assessable income from business	185,000	
2	Assessable income from investment	150,000	
3	Assessable income from employment	115,000	
Assessable income		450,000	450,000

CALCULATION OF TAXABLE INCOME

DEDUCTION FROM ASSESSABLEINCOME			
1	CRF [1/3 of the assessable income]	150,000	
2	Donation [Bir Hospital (an exempt entity)]	15,000	
Total of deductions		165,000	165,000
Taxable income			285,000

CALCULATION OF TAXABLE BASE

REDUCTION FROM TAXABLE INCOME		
REDUCTIONS:		
1	Individual limit	100,000
2	Others........(if any)	-
Total reduction from taxable income		100,000
Taxable base		185,000

CALCULATION OF TAX LIABILITIES

1	First Rs. 75,000 @ 15%	11,250
2	Next balance Rs. 110,000@25%	27,500
CALCULATION OF ADDITIONAL TAX		
1.5% of the taxable base of Rs. 110,000		1,650
Tax liabilities		40,400

REVIEW QUESTIONS AND CASES

1. What is donation? Explain with suitable example.

2. "Donation is not an expense. However, it is deducted from assessable income."

3. Differentiate between contribution to retirement fund by the employee and employer and investment made by any person having taxable income from business, investment and employment.

4. What are the basic reasons of deduction of retirement fund and donation amounts from assessable income?

5. An Entity disclosed the following particulars. You are required to calculate taxable income of the Entity.

1. Assessable income from business Rs. 2,500,000
2. During the previous year PC and R&D costs were incurred of Rs. 1,250,000 and Rs. 1,250,000 respectively.
3. Donation given to a Public High School, run by an NGO Rs.200,000
4. Donation to a political party Rs. 150,000.
5. Donation to Prime Minister Relief Fund Rs. 250,000

6. Mr. Ghale presented the following particulars. Calculate taxable income.

1. Assessable income from business — after deduction of PC and R&D costs Rs. 1,250,000 and Rs. 1,250,000 respectively — Rs. 2,500,000

2. Assessable income from investment Rs. 150,000

The person claims the following amounts for deductions:

1. Investment in CIT Rs. 160,000
2. Donation to an NGO that serves HIV victims (but it also produces handicraft goods for profit). Rs. 25,000
3. An aid to a beggar Rs. 2,000.
4. Donation to a political party that is registered on Election Commission Rs. 102,000

7. A person disclosed the following information for the previous income year. Calculate taxable income of the person.

Income from natural resources Rs. 940,000

The person claims the following amounts for deduction:

1. Miscellaneous expenses of natural resources Rs. 141,000
2. Investment in CIT Rs. 125,000
3. Donation to a religious trust Rs. 75,000

An inquiry upon him reveals the following facts:

1. He rented natural resources to a connected person. If it rented to other persons, income from natural resource shifted up by 25 percent.
2. Interest from domestic lending Rs. 15,000

8. Mrs. Jamial is an actress. She disclosed her assessable income for the previous year Rs. 2,600,000 which includes Rs. 2,050,000 from net gain from disposal of non-business taxable assets. She has contributed Rs. 380,000 under ARF. She has paid Rs. 10,000 for life insurance premium each her and her disable husband for the sum of Rs. 100,000 each.

Compute her taxable base for the relevant income year.

9. Mr. Lakaul is a retired government employee of 63 years age. He disclosed the following particulars for the previous year.

1. Gross pension income Rs. 205,000.
2. Assessable income from business —after deduction of R&D cost of Rs. 85,000 — Rs. 350,000
3. Dividend income (after withholding) from non-resident company of minor son Rs. 6,000.

He has claimed deduction for deposited Rs. 150,000 as ARF in CIT and donated amount of Rs. 25,000 to a club.

Required:

Compute taxable base for the relevant income year.

Chapter 14

Taxable Income and Selection of Taxable Base

14.1 CONCEPT OF TAXABLE INCOME

Amount of income on which tax is actually charged or the amount of income from which tax losses, personal allowances and other relieves must be deducted before arriving at the amount to which the tax rates are applied. ITA of Nepal defines taxable income is the assessable income less deduction for retirement contribution and gifts to exempt organization.

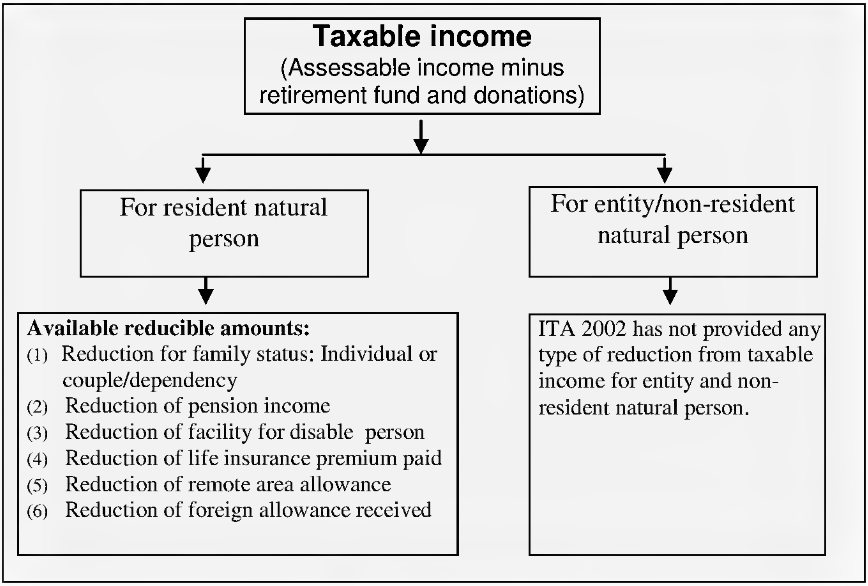
In calculation of person's taxable income, firstly assessable incomes from all the three income heads—employment, business and investment—are

aggregated in the income year. The value of aggregate assessable income is then reduced by contributions to approved retirement funds (if exists) and gifts to exempt organization to arrive at taxable income for the year.

Taxable base is the amount on which the tax rate is applied, e.g. corporate tax rate or individual tax rate. Taxable base is a bottom-line amount, taking into consideration all possible deductions, losses and personal allowances.

Taxable income differs from taxable base in the case of individual natural person. But, it does not differ in the case of entity. In the case of entity, taxable income and taxable base remains same.

Figure 14.1: Taxable income and calculation of taxable income (taxable base)



14.2 REDUCTIONS TO BE MADE IN CALCULATING TAXABLE BASE

A taxpayer is taxed on the taxable base (taxable income) for the income year. In calculating the taxable base, certain reductions are allowed from the taxable income. In this connection, the taxpayer may reduce one or more or all for which the person is eligible. Moreover, a disable individuals or couples are also eligible to reduce taxable income by 50 percent of the reduction of family status. All eligible reductions provided by ITA 2002 are presented in the following table 14.1.

Table 14.1: Calculation of taxable income (taxable base) for natural person

	Particulars	Individual		Couple/Dependency	
A	Taxable income		xxx		xxx
Reduction from taxable income:					
1	Reduction of individual or couple/dependency limit	100,000		125,000	
2	Reduction of pension income [not more than 25% of individual or couple/dependency limit or pension income]	xx		xx	
3	Reduction of facility for disable person (50% of the family status)	50,000	xx	62,500	xx
4	Reduction of life insurance premium paid [not more than 7% of insured amount or Rs. 10,000]		xx		xx
5	Reduction for remote area allowance (Rs. 6,000 to Rs. 30,000 as per remoteness)		xx		xx
6	Reduction of foreign allowance received (75% of the total foreign allowance received –if any)		xx		xx
B	Total of relief from taxable income		xxx		xxx
Taxable base [A-B]			xx		xx

14.2.1 Reduction of individual or Couple/Dependency Limit from Taxable Income [sc-1(1)(1/2)]

Reduction for individual or couple/dependency limit is the exempt amount from taxable income according to existing family status of the taxpayer: individual or couple/dependency. If a person is married or having dependency—having dependents including adapted dependents—or and selects income for the couple in tax purpose, the person gets Rs. 125,000 reduction from taxable income. In case person is married and selects to be treated as individual or an unmarried person gets relief of Rs. 100,000 from his taxable income. However, it is only available for resident natural person

EXAMPLE 14-1 A Lecturer of Tribhuvan University received taxable income of Rs. 700,000. If he is an individual person, his taxable base for the income year is calculated as:

Taxable income	700,000
Reduction of individual limit	(100,000)

Taxable base	600,000

EXAMPLE 14-2 Assume that same taxable income of **EXAMPLE 14-1**, if the lecturer has as a goodwife, his taxable base for the income year is to calculate as:

Taxable income	700,000
Reduction of couple limit	(125,000)
Taxable base	575,000

EXAMPLE 14-3 Assume that same taxable income of **EXAMPLE 14-1**, if the lecturer is unmarried or widower however, he bears cost of dependents. Also in this case, his taxable base remains same as couple.

14.2.2 Reduction of Pension Income Facility [sc-1(1)(9)]

Resident natural person who has an income from pension of previous job is additional provided reduction from taxable income. The reduction of pension income is additionally granted whichever is lower of pension income or 25 percent of reduction of individual or couple/dependency limit: individual Rs. 100,000 and couple Rs. 125,000.

EXAMPLE 14-4 A Fiscal Officer of a Firm expected his taxable income Rs. 500,000. The taxable income also includes pension income of Rs. 50,000 from his previous job. If the Fiscal Officer is elected as an individual for the year, his taxable base is calculated as:

Taxable income			500,000
Reduction:	(1) Individual limit	100,000	
	(2) Pension income facility	25,000	
Total of reductions		125,000	125,000
Taxable base			375,000

EXAMPLE 14-5 Refer to back **EXAMPLE 14-4,** if the Fiscal Officer elects as a couple for the year, his taxable base is calculated as:

Taxable income			500,000
Reduction:	(1) Couple limit	125,000	
	(2) Pension income facility	31,250	
Total of reductions		156,250	156,250
Taxable base			343,750

14.2.3 Reduction of Disable Facility [sc-1(1)(9a)][1]

Finance Act 2063 has provided additional facility to disable persons. According to provision, any resident natural persons who disable by any reason can get additional facility on reduction of family status — 50

[1] Inserted by the Finance Act 2063 dated Srawan 1, 2063.

percent of the reduction of the family status: for individual 50 percent of the Rs. 100,000 and for couple 50 percent of the Rs. 125,000.

EXAMPLE 14-6 A disable teacher of Khagendra Nava Jivan School expected his taxable income Rs. 400,000. He has received pension income Rs. 28,000 from his previous job. He has elected to him as an individual for the year. In this context, his taxable base is calculated as:

Taxable income			400,000
Reduction:	(1) Individual limit	100,000	
	(2) Pension income facility	25,000	
	(2) Disable facility	50,000	
Total of reductions		175,000	175,000
Taxable base			225,000

EXAMPLE 14-7 Refer to back **EXAMPLE 14-6,** if the disable teacher elects to him as a couple for the year, his taxable base is calculated as:

Taxable income			400,000
Reduction:	(1) Couple limit	125,000	
	(2) Pension income facility	28,000	
	(2) Disable facility	62,500	
Total of reductions		215,500	215,500
Taxable base			184,500

EXAMPLE 14-8 Refer to back **EXAMPLE 14-6,** if the disable teacher is unmarried but he has to liable to sustain other disable person, his taxable base remains same as to couple.

14.2.4 Reduction of Life Insurance Premium Paid to Investment Insurance [sc-1(1) (10)]

Resident natural person can claim and deduct life insurance premium paid for insurance investment from his taxable income. It is available whichever is lower between seven percent of insured amount or Rs. 10,000. Reduction for this purpose is given first priority in tax calculation.

EXAMPLE 14-9 A Secretary of the Government of Nepal received taxable income Rs. 350,000. He has insured by a sum of Rs. 200,000 and paid insurance premium Rs. 15,000. If the secretary is elected as an individual for the year, his taxable base is calculated as given below:

Taxable income			350,000
Reduction:	(1) Individual limit	100,000	

	(2) Life insurance premium	10,000	
Total of reductions		110,000	110,000
Taxable base			240,000

EXAMPLE 14-10 A Lecturer of Kathmandu University received taxable income Rs. 305,000. He has insured by a sum of Rs. 100,000 and paid insurance premium Rs. 6,000. If the lecturer has kept an adapted son, then his taxable base for the year is calculated as:

Taxable income		305,000
Reduction: (1) Dependency limit (equal to couple)	125,000	
(2) Life insurance premium	6,000	
Total of reductions	131,000	131,000
Taxable base		174,000

14.2.5 Reduction of remote area allowance [sc-1(1) (5)]

Reduction of remote area allowance is another reduction from taxable income for natural person who is residing in remote area and gets remote area allowances. This allowance is classified into five groups according to their remoteness. It varies from Rs. 6,000 to Rs. 30,000 as prescribed by the Government of Nepal as presented in table 14.2.

Table 14.2: Classification of remoteness and limit of allowance

Classification	Limit of reduction in Rs.	Classification	Limit of reduction in Rs.
A	30,000	D	12,000
B	24,000	E	6,000
C	18,000		

Classification of remote areas prescribed by the Government of Nepal for the purpose of remote area allowance:

☐ Remote Areas of Class A

1. Manang, 2. Kalikot, 3. Mugu, 4. Dolpa, 5. Humla, and 6. Bajura districts

☐ Remote Areas of Class B

1. Dhunsa, Olangchung Gola and its VDCs of Taplejung district, 2. The following VDCs of Sankhuwa Shabha district: a. Chepuwa, b. Hedangna, c. Kimathanka, d. Yaksila, e. Valung, and f. Simajor. 3. The following VDCs of Solukhumbu district: a. Khumjung, b. Namche, and c. Chaurikharka. 4. Gogar VDC of Dolakha district. 5. Timur VDC of Rasuwa district: 6. The following VDC of Gorkha district: a. Sirdibas, b. Prok, c. Loha, d. Keroja, e. Chhekampar and f. Manbu . 7. The following

VDCs of Baglung district: a. Bodang, b. Nisi, c. Hukam, d. Ranma, e. Maikot, and f. Takbachhi, 8. Mustang, 9. Jumla, 10. Bajhang, 11. Area of Khaptad Jadibuti Udhyan of Doti district above altitude of 900 feet. 12. Darchula district

☐ Remote Areas of Class C

1.Rukum, 2. Jajarkot, 3.Dailekh, and 4. Achham district.

☐ Remote Areas of Class D

1. VDCs of Taplejung district other than those falling in class B. 2. Bhojpur, 3. Terhathum, 4. VDCs of Sankhuwa Shabha district other than those falling in category-B. 4. Khotang, 5. Okhaldhunga, 6. VDCs of Solukhumbu district other than those falling in category-B. 7. The following VDCs of Dhading district: a. Budathum, b. Lapa, c. Phulkharka, d. Rigaun, e. Salyankot, f. Salyantar, 8. The following VDCs of Sindhupalchok district: a. Baramcho, b. Baruwa, c. Mautada, d. Birat Golade, e. Gunsa, f. Guwa, g. Kiul, h. Listikot, i. Mahangkal, j. Pang Tang, k. Phulping Katti, l. Dhagpalkot, m. Timulthagal Tinas Dhyagal, n. The following VDCs of Lamjung District: a. Bahundada, Mahendrodaya, b. Shree Kali Katadhi, c. Thuli Besi Patangi, d. Thakan Phalikadevi, 9. Myagdi, 10. Rolpa, 11.Salyan, 12. Pyuthan 13. VDCs of Doti district other than those falling in category-B. 14. Dadeldhura, 15. Baitadi.

☐ Remote Areas of Class E

1. Panchthar, 2. Dhankuta, 3.Ramechhap, 4.Dolakha, 5. VDCs of Rasuwa district other than those of class 6. VDCs of Dhankuta district other than those of class D. 7. VDCs of Dhading district other than those of class D. 8. VDCs of Lamjung district other than those of class D. 9. VDCs of Gorkha district other than those of class B. 10. Gulmi 11. Arghakhanchi, 12. Parbat, 13. VDCs of Baglung district other than those of class B.

EXAMPLE 14-11 A Local Development Officer of Dolpa District expected to receive his taxable income Rs. 450,000 including pension income from his previous job Rs. 26,000. He has insured by a sum of Rs. 150,000 and paid insurance premium Rs. 10,500. If the secretary is elected as a couple for the year, his taxable base is calculated as given below:

Taxable income			450,000
Reduction:	(1) Couple limit	125,000	
	(2) Pension income	26,000	
	(3) Life insurance premium	10,000	
	(4) Remote area allowance	30,000	
Total of reductions		191,000	191,000
Taxable base			259,000

EXAMPLE 14-12 A teacher of Dhankuta District calculated his taxable income Rs. 255,000. If the teacher has kept an adapted son, then his taxable base for the year is calculated as:

Taxable income			255,000
Reduction:	(1) Dependency limit (equal to couple)	125,000	
	(2) Remote area allowance	6,000	
Total of reductions		131,000	131,000
Taxable base			124,000

14.2.6 Reduction of Foreign Allowance Facility [sc-1(1)(5)]

Additional reduction from taxable income is made 75 percent of the foreign allowance to arrive at taxable base if staffs of the Government of Nepal working in foreign diplomatic missions or embassies get foreign allowance[2].

EXAMPLE 14-13 A Foreign Sectary posted abroad Embassy of Nepal to Vietnam in Hanoi. During the year he calculated his taxable income of Rs. 600,000. The taxable income includes foreign allowance Rs. 300,000 and family allowance Rs. 100,000. In this situation, his taxable base is calculated as given below:

Taxable income			600,000
Reduction	(1) Couple limit	125,000	
	(2) Foreign allowance facility	225,000	
Total of reductions		350,000	350,000
Taxable base			250,000

14.3 CALCULATION OF TAXABLE INCOME (TAXABLE BASE) FOR NON-RESIDENT NATURAL PERSON

According to schedule one, non-resident person can not get any reduction from taxable income to arrive at tax base. Thus, tax base for non-resident natural person is equal to taxable income.

EXAMPLE 14-13 A person showed taxable income of Rs. 680,000 including pension income of Rs. 36,000 from his previous job of Nepal. He has paid insurance premium Rs. 7,000 for the sum of Rs. 100,000. However, he stayed in Nepal for 160 days for the year. In this context, his taxable income is calculated as given below:

Taxable income			680,000
Reduction:	(1) Individual limit	Not	

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[2] Inserted by the Finance Act 2063 dated Srawan 1, 2063. But it was practiced since 2061.

	(2) Pension income	available for non-resident	
	(2) Life insurance premium		
Total of reductions			Nil
Taxable base			680,000

14.4 CALCULATION OF TAXABLE INCOME (TAXABLE BASE) FOR ENTITY

Entities are artificial person. Thus, any reductions from taxable income are not provided to artificial persons. Companies, Partnership Firms, NGOs, Trust, Foreign Permanent Establishment, and Bodies of the Government of Nepal etc are example of artificial person.

CASES AND SOLUTIONS

1. A resident natural person (individual) disclosed taxable income (after deduction of donation) Rs. 750,000 for the relevant income year. The taxable income also includes pension income Rs. 32,000 and remote area allowance Rs. 45,000. The person has claimed the reduction of life insurance premium Rs. 17,000 (paid to life insurance policy of Rs. 200,000) from taxable income.

You are required to calculate taxable income (taxable base) for the relevant income year.

Solution:

Calculation of taxable income (taxable base) of a resident natural person for the income year 2063/064

Particulars	Amount	Amount
Taxable income (after deduction of donation amount)		750,000
REDUCTION FROM TAXABLE INCOME		
1 Reduction: (a) Individual limit	100,000	125,000
(b) Pension income	25,000	
2 Reduction of life insurance premium		10,000
3 Reduction to remote area allowance		30,000
Total of reductions from taxable income		165,000
Taxable base		585,000

Clarification:

1. Rule for reduction to life insurance premium from taxable income stands, not exceeding 7 percent of the insured amount or Rs. 10,000. Thus, in the above case, the rule applies of Rs. 10,000.

2. Reduction for individual or couple/dependency is Rs. 100,000 and Rs. 125,000 respectively for the year. Thus, the above case agrees to Rs. 100,000 of an individual.
3. Rule of pension income observes not exceeding 25 percent of reduction given to individual or couple/dependency. Thus, 25 percent of the Rs. 100,000 for an individual is to deduct for pension income.
4. Reduction to remote area allowance is given from Rs. 6,000 to Rs. 30,000 as to remoteness. In the absence of declaration of place, it needs to consider two things: remote area and amount of allowance. Thus, not more than remote area allowance Rs. 30,000 is provided in the above case.

2. A non-resident person disclosed the following particular. You are required to ascertain his taxable income (taxable base) for the relevant income year.

1. Assessable income Rs. 750,000.
2. Donations: (a) Football Club (exempt entity) Rs. 15,000.
   (b) Donation to PDT Rs. 20,000
3. Life insurance premium paid to investment insurance Rs. 7,000
4. Pension income Rs. 30,000.

Solution:

Calculation of taxable income (taxable base) of a non-resident person for the income year 2063/064

	Particulars	Amount	Amount
Assessable income			750,000
DEDUCTION FROM ASSESSABLE INCOME			
1	Donation (to Football Club)	15,000	
2	Donation to PDT	20,000	
Total of deductions from assessable income		35,000	35,000
Taxable income			715,000
REDUCTION FROM TAXABLE INCOME			
1	Reduction for family status (for individual)	Not available for non-resident person	
2	Reduction for pension income facility		
3	Reduction for life insurance premium paid		
Taxable base			715,000

In case of non-resident person taxable base equals to taxable income. Similarly, taxable base of an entity equals to taxable income. The taxable base or taxable income of an entity and a non-resident person is obtained only after deduction of donation amount. Both persons do not contain any reductions from taxable income.

Chapter 15

Selection of Tax Rate and Calculation of Tax Liabilities

15.1 CONCEPT OF TAX RATE

Tax rate is the percentage of levy on tax base from an income to pay tax. Wikipedia states that taxes are most often levied as a percentage, called the tax rate, of a certain value, the tax base. Tax rate can be applied in a number of ways, but is usually expressed as a percentage or as a fixed amount. If expressed as percentage, the tax rate can be progressive, flat or, in rare cases, degressive. Whichever type of tax rate is used, the tax rate is applied on the taxable base, which differs depending on the nature

of the tax concerned. To apply the percentage of tax rate, certainly there should be an *ad valorem* tax where the tax base is the value of goods, service, or property. Sales taxes, tariffs, property taxes, inheritance taxes, and value added taxes (VAT) are different types of ad valorem tax. The ad valorem tax is typically imposed at the time of a transaction (sales tax or VAT) but it may be imposed on an annual basis or in connection with another significant event. An alternative to the ad valorem taxation is an excise tax, where the tax base is the quantity of something, regardless of its price: for example, in the United Kingdom, a tax is collected on the sale of alcoholic drinks that is calculated by volume and beverage type rather than the price of the drink.

There are different tax rates: tax rates, marginal tax rates and average tax rates. The average rate is the total tax paid divided by the total amount the tax is paid on, while the marginal rate is the rate paid on the next rupees of income earned. In a "progressive" tax system, these can be very different.

EXAMPLE 15-1 A person calculated his taxable base Rs. 40,000. If prevailing tax law fixes tax at the rate of 15 percent, tax liability of the person is determined Rs. 6,000.

EXAMPLE 15-2 Refer to back **EXAMPLE 15-1,** if the prevailing tax law fixes first limit/bracket of Rs. 15,000 at the rate of 15 percent and next limit/bracket of Rs. 25,000 at the rate of 25 percent, the tax liability of the person is to calculate based on both limit as given below:

Limits/brackets	Tax rate	Tax liabilities
First limit of Rs. 15,000	15	2,250
Next limit of Rs. 25,000	25	6,250
Total tax liability of the person		8,500

EXAMPLE 15-3 Suppose that a person calculated his taxable base Rs. 250,000. There are six limits/brackets of amounts and rates in prevailing tax law. The person's tax liability is determined according to given brackets/limits. The limit, which is touched by the taxable base, is said marginal rate.

EXAMPLE 15-4 Refer to back **EXAMPLE 15-3**, if the prevailing law fixes six tax limit/brackets of the rate of 15 to 50 percent as given below, the tax liability and marginal rate of the tax is known as:

Limits/brackets		Tax rate	Tax liabilities
1	First limit on Rs. 15,000	15	2,250
2	Next limit on Rs. 25,000	25	6,250
3	Next limit on Rs. 50,000	30	15,000
4	Next limit on Rs. 100,000	35	35,000
5	Next limit on Rs. 150,000 but for Rs. 60,000	40	15,000
6	In balancing on Rs…	50	-
Tax liabilities			73,500
Average tax rate [Rs. 73,500/Rs. 250,000×100)			29.40

According to the above calculation, the marginal tax rate and average tax rate of the person are understood as 40 percent and 29.40 percent respectively.

Tax rate can be applied in a number of ways, but is usually expressed as a percentage or as a fixed amount. If expressed as percentage, the tax rate can be progressive, flat or, in rare cases, degressive. Whichever type of tax rate is used, the tax rate is applied on the taxable base, which differs depending on the nature of the tax concerned.

15.2 TAX RATE STRUCTURES

On the basis of structure tax rate can be: proportional, progressive, regressive and degressive. With a proportional (or flat) tax rate, the average rate remains the same as the taxable base increases. In Nepal, most of the tax rates are proportional or flat. The tax rates of final withholding payment, tax rate of entity and tax rates to non-resident natural persons are the examples of proportional taxes.

In a proportional tax, the tax rate remains same when taxable base increase or decrease.

EXAMPLE 15-5 If a prevailing tax law of a country fixes 10 percent tax on income, this percent is applied all the levels of income earned by persons and are taxed at the rate of 10 percent.

Progressive tax is defined as a tax whose rate increases as the payer's income increases. The taxpayers who earn high incomes have a greater proportion of their incomes taken to pay the tax.

EXAMPLE 15-6 Suppose that taxes for a family with an income of Rs. 20,000 are 20 percent of income and taxes for a family with an income of Rs. 200,000 are 30 percent of income, then the tax structure over that range of incomes is progressive. One tax structure

is more progressive than another if its average tax rate rises more rapidly with income.

The following is presented a numerical explanation to justify idea of the progressive taxation.

Taxable income/tax brackets intervals	Tax rate	Tax liability
First Rs. 75,000	15%	11,250
Next Rs. 100,000	20%	20,000
Next Rs. 150,000	25%	37,500
Next Rs. 175,000	30%	52,500
Tax liabilities		121,250

As depicted in the above example, the taxpayer has to pay largest amount of tax from marginal rate and average tax rate is always below the marginal rate in progressive taxation.

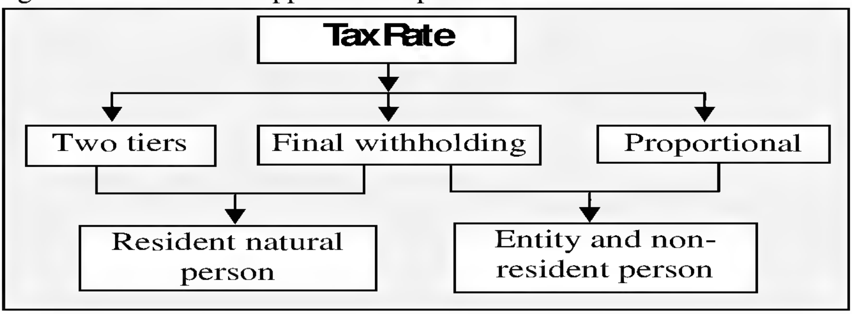
Regressive tax is just adverse tax structure of progressive tax. The regressive structure is one where the average rate decreases when the taxable base increases. Most of scholars feel that sales tax is a regressive tax. This is because if the total sales tax paid by a taxpayer is divided by income the average rate decreases in income.

EXAMPLE 15-7 Person 'A' earns Rs. 100,000 per year. He spends Rs. 20,000 of this income on purchases of food, clothing, and medicines, which are subject to a 7% sales tax. Person 'B' earns Rs. 50,000 and spends the same amount on the same items. Thus, both pay Rs. 1,400 in sales taxes. B's rate is (Rs. 1,400 divide by Rs. 50,000 multiply by 100) 2.8%; 'A's is (Rs. 1,400 divide by Rs. 100,000 multiply by 100) 1.4%. Thus, this tax is regressive in income.

15.2.1 Tax Rate Structure in Nepal

Tax rate structure of Nepal may be divided into three groups: (1) two tiers or brackets progressive or degressive tax, (2) proportional tax, and (3) final withholding rated.

Figure 15.1: Tax rates applicable to persons



☐ Two Tiers or Brackets Tax Rate Structure

Two tiers tax rate structure of Nepal refers degressive (taxation) tax structure. The degressive tax is a mixed rate of proportional and progressive taxation. Thus, is neither progressive nor proportional. In Nepal, it is kept on two brackets/limits: 15 percent and 25 percent.

☐ Final Withholding

Final withholding rates are always imposed on flat tax rate basis. These are imposed on income not taxable base. In final withholding, an income without deduction equals taxable base.

☐ Proportional Tax

Proportional tax rate always remains same if taxable base increases or decreases. Thus, in proportional tax, rate of tax is fixed for any amount of taxable income/taxable base.

15.2.2 Selection of Tax Rates

Persons are divided into two categories for tax purposes: resident natural person and entity.

☐ Resident Natural Person

Resident natural person includes an individual, couple and sole proprietorship business. A sole proprietorship business never separated from an individual or couple. Thus, tax rate for the couple and individual is applied as shown below:

S.No.	Taxable base	Tax rates
Two tiers structure:		
1	First rupees 75,000 at the rate of	15%
2	In balance rupees ……. at the rate of	25%
Additional tax:		
3	For the last limit at the rate of	1.5%

☐ Entity and Non-resident Person

Entity includes partnership, company, Government bodies, trusts, corporations, or any business or non-business organization excluding sole proprietorship business. The entity and non-resident person can also be divided into two categories: financial institution and other entities.

1. **Financial institution and banking business:** The tax rate for the financial institution and banking business applies as given below:

S. No.	Taxable income	Tax rates
PROPORTIONAL		
1	Taxable income rupees…….at the rate of	30%
ADDITIONAL TAX		

2	Taxable income rupees ......at the rate of	1.5%

2. Other entities and non-resident person: The tax rate for the entity and non-resident natural person applies as given below:

S.No.	Taxable income	Tax rates
PROPORTIONAL		
1	Taxable income rupees......at the rate of	25%
ADDITIONAL TAX		
2	Taxable income rupees.....at the rate of	1.5%

15.3 CALCULATION OF TAX LIABILITY

Taxes are computed by multiplying the tax rate by the tax base i.e. TAX RATE × TAX BASE = TAX AMOUNT. The tax base is the amount, which is subject to tax. For income taxes, the tax base is "taxable income", defined roughly as income less allowable expenses.

The scope of tax liability of a person in a country depends on tax system employed by country. Usually there are two principles: application of the residence principle of taxation and application of the source principle of taxation.

Application of the residence principle of taxation levies taxes on worldwide income whereas application of the source principle of taxation levies tax only on income, which arises within its territory.

Residence taxation applies to resident person (in case of individuals where the person has his home or usual place of abode; in case of companies where the company is incorporated or has its seat and/or general place of management) that person will usually be "subject to unlimited taxation" (worldwide taxation). Source principle of taxation applies to non-resident person of the country, tax will be levied only on income, which arises within its borders, and the person is then "subject to limited taxation".

15.4 MEDICAL TAX CREDIT

Medical tax credit may be available to resident natural person. It reduces tax liability to be paid. However, it is limited in amount. Thus, the medical tax credit is provided not more than 15 percent of medical treatment expenses or Rs. 750.

CASES AND SOLUTIONS

1. A resident person disclosed taxable income/taxable base Rs. 750,000 for the relevant income year. His medical treatment cost prescribed by doctor was Rs. 9,000. Calculate tax liability.

Solution:
Calculation of tax liability of a resident natural person for the income year 2063/064

Particulars		Amount
Taxable base		750,000
CALCULATION OF TAX LIABILITY		
1	First limit Rs. 75,000 @ 15 %	11,250
2	In balance Rs. 675,000 @ 25%	168,750
CALCULATION OF ADDITIONAL TAX		
3	1.5% of the taxable base Rs. 675,000	10,125
Tax liability before medical tax credit		190,125
CALCULATION OF MEDICAL TAX CREDIT		
Not more than 1.5% of medical treatment expense or Rs. 750		750
Tax liability		189,375

Clarification:
Excess amount Rs. 4,000 of medical tax treatment expense is transferred to the later year for the medical tax credit.

2. A non-resident person disclosed taxable income Rs. 750,000 for the relevant income year. His medical treatment cost prescribed by the doctor is Rs. 9,000. Calculate his tax liability.

Solution:
Calculation of tax liability of a non-resident natural person for the income year 2063/064

Particulars		Amount
Taxable income		750,000
CALCULATION OF TAX LIABILITY		
1	Taxable income Rs. 750,000 @ 25 %	187,500
CALCULATION OF ADDITIONAL TAX		
2	1.5% of the taxable income Rs. 750,000	11,250
Tax liability		198,750

Clarification:

To get medical tax credit, a person must be resident natural person. Thus, the non-resident natural person is not eligible for medical tax credit.

3. A resident entity disclosed taxable income Rs. 750,000 for the relevant income year. Its advance tax is Rs. 200,000. Calculate tax liability, payable tax amount and tax credit.

Solution:

Calculation of tax liability of a non-resident natural person for the income year 2063/064

Particulars		**Amount**
Taxable income		750,000
CALCULATION OF TAX LIABILITY		
1	Taxable base Rs. 750,000 @ 25 %	187,500
CALCULATION OF ADDITIONAL TAX		
2	1.5% of the taxable income Rs. 750,000	11,250
Tax liability		198,750
Less:	Advance tax	200,000
Tax credit/Advance tax		1,250

Clarification:

If the tax liability exceeds advance tax or tax credit that results tax payable amount and if the advance tax or tax credit exceeds tax liability that results tax credit or advance tax.

Chapter 16

Assessment of Tax and Return of Income

16.1 Assessment

Assessment applies to the act of ascertaining and adjusting the tax due as well as to the document or record in which the details of calculation and tax are noted. It is sometimes related to estimation of tax made in the absence of a return or declaration by the taxpayer. Income tax paid by withholding and installment are only tax credit or advance tax liability if not converted into final payment of tax. The assessment requires overall appraisal of the taxpayer's income tax liability for the income year with appropriate accounting of the withholding (if not final) and installment

payment. For the purpose of assessment Inland Revenue Office requires filing of income tax return.

ITA 2002 adopts fully self-assessment system. However, there are also other types of assessment to ascertain taxpayer's tax liability for an income year.

16.1.1 Types of Assessment

Specially, there are three types of assessment: self-assessment, jeopardy assessment and amended assessment.

☐ Self-Assessment [§99]

Self-assessment is a system under which the taxpayer is required to declare the basis of his assessment to submit a calculation of the tax due and, usually, to accompany his calculation with payment of the amount he regards as due. In this system, taxpayers are generally required to complete an annual tax return and submit it to the IRO before a statutory filing deadline. There is also a general requirement for the taxpayer to calculate his or her own tax liability although in certain circumstances the IRO will calculate the tax liabilities of individuals or entity, if occurs jeopardy or amended assessment. The tax liability so calculated must be paid by fixed payment dates (as installment for installment taxpayer holders) in order to avoid additional interest charges.

IBFD mentions that in the self-assessment the role of the tax authorities is to check that the taxpayer has correctly disclosed his income and has claimed no relief's or allowances to which he is not entitled, and otherwise to ensure that he pays the correct amount of tax. It contrasts with their role in systems where the tax authorities are responsible for establishing the tax due and demanding payment. In practice, the distinction between self-assessment and other systems may be obscured by such factors as withholding of tax at source from investment income or wages and salaries, and the inability of tax authorities in some circumstances to ascertain with much precision the trading profits of individuals. The system is normally adopted for all types of transfer tax and turnover tax; some countries also apply this system to the income tax.

According to §96, a taxpayer has an obligation to submit tax returns at the place prescribed by the IRD no later than three months after the end of each income year. As provision mentioned in §99, in case a person submits a tax return including the information regarding the tax payable during the year and the tax due for payment on the date of submission of

return is considered as (that) completion of income tax assessment. Self-assessment may be generalized into the following three basic rules.

1. As established norms of self-assessment the filing of an annual return with the required value is treated as assessed by the IRO if not the conditions of jeopardy assessments and amended assessment occurred.
2. In case of non-filing an assessment is deemed as assessed as made with regard to tax withheld or installment paid to the IRO. It is taken into account as that there is no more tax payable for year by the person as paid by withholding or installment.
3. In case of non-income of the person notice of the assessment is not required to the IRO.

☐ Jeopardy Assessment [§100]

Generally jeopardy assessment is made where there is some danger of tax being lost e.g. where a taxpayer tries to place his assets beyond the reach of the collection machinery when an investigation into his tax affairs is initiated. Thus, according to §100 jeopardy assessment is best judgment of the IRD.

Simply in best judgment assessment the tax authorities are authorized to make an assessment according to the best of their judgment in certain cases. In many countries the conditions for making best judgment assessment are normally along the following lines:- the taxpayer fails to make a required return of his income; -the taxpayer fails to produce required accounts, documents, information or a statement of assets and liabilities; -the taxpayer, having made a return, fails to appear at the tax authorities' office to produce documents or evidence; -the taxpayer fails to comply with a directive issued by the tax authorities regarding an audit of his accounts. However, in Nepal, the jeopardy assessments are required only under any one of the following circumstances:

- If the taxpayer becomes bankrupt, is in over debt, or goes into liquidation,
- If the taxpayer is about to leave Nepal for indefinite duration,
- If the person is about to cease the ongoing activity in Nepal owing to any reason, or
- If the Inland Revenue Department (IRD) otherwise considers it appropriate.

Under any one of the above circumstances, the tax authorities may require the taxpayer to file an early return of income prior to the regular date of filing a return or instead may make an assessment according to best judgment of the tax administration for any time of the income year. However, it should be informed to the taxpayer. In jeopardy assessment

the taxpayer could not assess his tax liability. It is assessed by the IRD on the basis of best judgment and taxpayer must pay this amount of tax. Jeopardy assessment may be whole year or part of year. If the jeopardy assessment refers to a part of an income year the taxpayer is still required to file a return of income for remaining part of the year and if the jeopardy assessment is made for a full income year the person do not require to file a return of income.

☐ Amended Assessment [§101]

Amended assessment refers to the correction and assessment on the taxpayers assessment by the tax authorities. Especially it is done if an original assessment is incomplete or incorrect in any material respect. The IRD can amend a self-assessment and jeopardy assessment filed by any person, if it considered justified adjusting the assessed person's tax liability as per the objectives of the Income Tax Law. The power to make an amended assessment is restricted after time period of 4 income years. However, the time limitation is avoided in case of fraud. The amended assessment requires written notice to the taxpayers and it includes: -amount of paid tax and or still to be paid; -the period of time to which the assessment relates; -the calculation of tax payable or still to be paid; -the date at which the tax must be paid, and -the time, place, and manner of objection to the assessment.

16.2 RETURN OF INCOME

Tax return indicates the collection of government forms on which earnings and expenses are recorded in order to calculate the tax liability of an individual or entity. It is filed in the IRO with the financial statement showing the profit or loss sustained by a person during a particular period, including all items of income and expenditure. The return of income tax and its assessment is the crucial part of the income taxation. Nepal applies completely self assessment system. Thus, the tax returns require declared amount of tax with a proof from assessee's side. For this purpose, the IRD has designed the formats for every sources of income. According to these forms taxpayers are required to fill tax returns with the required data or amount taken from the accounts whatever occurred during the year. Moreover, tax returns require the following commitment signing in the given forms about:

- Causes of selection of taxpayer
- True and fair statement
- Truly disclosed required data
- Complete data
- Responsible or liable to be penalized according to law.

16.2.1 Types of Return of Income Tax

ITA 2002 includes three types of returns: annual tax returns, withholding, and installments.

☐ **Annual Tax Return**

According to §96, every taxpayer has to file at the place prescribed by the IRD, a return of income for the year not later than three months after the end of each income year. However, §97 has made some flexibility to that compulsory provision. It clears that unless requested by the IRD, by notice in writing to the person, no return of income for an income-year is to be required from the following person.

- If the person has no tax liability during the year,
- If the person received the final withholding payment during the income year,
- A resident individual to whom the following conditions apply,
  a) If the income for the income year consists exclusively of income from employment having a source in Nepal,
  b) If an individual has only one employer at a time during the year all of whom are resident employers,
  c) If one claims only deduction of retirement contribution and medical tax credit but does not claim a reduction of donation amount given by him during the year, and
  d) A natural person having income from vehicles and whose income tax is fixed on the annual basis.

However, if the IRD order in written or publish a public notice to file tax returns; in this situation the above stated facilities are not available.

1. Extension of time to file return of income: Every taxpayer has a statutory obligation to file the annual tax return in the prescribed place within three months after the end of the income year. However, it may be extended more than three months where a person makes a written request to the IRD by the due date for filling the return, the IRD may, on such terms and conditions as prescribed by the IRD (including as to payment of security) and where reasonable cause is shown, extend the date by which the return is to be filed; and can serve the person with written notice of the IRD decision on the application.

EXAMPLE 16-1 A person made a written request to extend period to submit tax return. In this context, if all the dues are paid and the reason is genuine, the IRD may extend time not more than three months to file return of income.

EXAMPLE 16-2 Suppose that the above person received permission of extension only for one month at first. It was not sufficient for him. Again, he made a written request to submit his tax return to the IRD. The IRD may permit him extending time to file return of income but it may not be more than three months including prior extension.

Moreover, the IRD may grant multiple extensions but the extensions are not extended in total of three months.

☐ Jeopardy Tax Returns

Under the given circumstances the IRD may serve a notice in writing to the taxpayer to submit a tax return for the year or part of the year within a specified date or prior to the date. The circumstances are:

- If the person becomes bankrupt, is in over debt or goes into liquidation;
- If the person is about to leave Nepal for indefinite time;
- If the person is about to cease the ongoing activity in Nepal owing to any reason; and
- If the IRD otherwise considers it appropriate.

According to the provision, if any taxpayer receives this jeopardy assessment notice, the taxpayer has to submit the return for the period given in the notice within the prescribed time.

☐ Installments

ITA 2002 applies principle of Pay-As-You-Earn (PAYE) system. The PAYE is important and easy-to-collect revenue. Simply installments and withholding are the estimated taxes. Income taxes which are paid on a periodic basis by a taxpayer whose income is not subject to a withholding tax. The amount remitted to the tax authorities represents an "estimation" of total tax liability for the particular taxable period. Various other terms are used to describe the same concept e.g. provisional tax, advance tax etc.

1. Payment of installments [§94]: According to provision persons who derive or expect to derive any assessable income during an income year from business or investment are required to pay tax for the year by three installments given as below:

Table 16.1: Tax returns for installments

Installments	Payable date	Amount of payable
First	At the end of Poush	40% of the estimated tax to the extent to which it is excess of the tax paid.
Second	At the end of Chaitra	70% of the estimated tax to the extent to which it is excess of the tax paid.

Third	At the end of Ashadh	100% or the estimated tax to the extent to which it is excess of the tax paid.

EXAMPLE 16-3 A person paid Rs. 100,000 as income tax from self assessment for the previous year. In the current year, the person requires not less than Rs. 40,000 for the first installment at the end of Poush.

EXAMPLE 16-4 Suppose that if the person has estimated for the more/less tax liability for the year as can earn upto the end of year, he should pay on the basis of 40 percent of the current year's estimated income tax liability for the first installment. If it differs in second or last the estimation and payment of tax is to adjust accordingly.

EXAMPLE 16-5 Assume that if the persons paid less/more tax from their estimation for the income year in any installment, in these circumstances, it has to be adjusted from later installments including interest imposed to the date.

These installments are compulsory and are treated as advance tax for the income year. However, the installments are not obliged to the taxpayers as given below:

- If the person has solely income from employment,
- If the person falls under the presumptive taxpayer,
- If the person has an amount of an installment calculated as prescribed is less than Rs. 2,000.

Thus, installments are compulsory returns other than solely employment income and presumptive taxpayers.

Estimated tax is to be either based on estimate for the income year or payment of the previous year's tax and these installments are adjusted for that year according to liabilities borne by the annual tax returns. If at the end of the year a final tax liability remains to be paid, as, for example, a result of the income tax return filed at the end of the year the income tax paid by installments is credited against this liability.

2. Statement of estimated tax [§95] and e-filling: An e-filing is electronic transmitted of return of income. In Nepal, it has been operating since Poush 2063. This mode of filing enhances the speed and efficiency to collect the revenue. It makes short for processing of collection. However, taxpayer can cheat to the government adopting the criminal method.

In Nepal, every person who is an installment payer has to submit for the income year in advance an estimate of his tax payable. Moreover, this statement is to be submitted within the prescribed format of e-filling. In the estimated income statements of e-filling the following facts are to be specified:

- The person's assessable income to be derived for the income year from employment, business, and investment and the source of this income,
- The person's taxable income to be derived for the income year,
- The person's tax to become payable calculated without reduction for any medical tax credit,
- In the case of foreign permanent establishments of non-resident persons situated in Nepal, need to refer to their repatriated income and the tax on that income.

Estimation of installment payers remains enforceable unless it is revised for the year. It means if a person submits his estimation for the first installment it remains enforceable if the payer does not revise it for that year. Thus, the taxpayer needs to revise it if his income fluctuates in the later months of the year.

☐ Withholding Payments

Withholding refers tax on income imposed at source, i.e. a third party is charged with the task of deducting the tax from certain kinds of payments and remitting that amount to the IRD. Withholding taxes are found in practically all tax systems and are widely used in respect of dividends, interest, royalties and similar payments. Where wages and salaries represent the underlying taxable payment, a wage tax is usually levied as a withholding tax. Withholding tax may be provisional or final. If provisional, the amount withheld will be credited against the taxpayer's final tax liability and adjusted accordingly. If final, no subsequent adjustments will be made. The rates of withholding tax are frequently reduced by tax treaties. In fact, certain jurisdictions qualify as tax havens by virtue of the exemptions or reductions in the rates of withholding taxes to which its residents become entitled in accordance with the provisions of one or more tax treaties.

All withholding taxes aim to tax income when it is earned, only withholding on wages is commonly known as PAYE. This tax plays an important role in nearly all national tax systems.

Final withholding tax needs no further calculation or determination of income tax with regard to the received payment. But if withholding tax is

not final the withholdee is entitled to a tax credit equal to withheld tax. This tax credit is claimed by the withholdee through filing of income tax return and it is deducted from (to be paid tax liability) liability to be paid.

For details refer to chapter 6: Withholding

REVIEW QUESTIONS AND CASES

1. "Theory of self-assessment based on the optimum strategy of game theory: one cut the cake, while the other chooses cake larger one." Comment.
2. Jeopardy assessment is the best judgment of the IRD. Comment its strengths and weaknesses.
3. Write down procedures of amended assessment.
4. "Withholding payments are based on the principle of PAYE." Discuss.
5. "Provisions of installments and its percentage of installments are truly reasonable in Nepalese context." Do you agree with this statement? Comment.
6. In the self assessment system, the role of the tax authorities is to limit on the check of return of income only in random basis. Have you the same opinion? Give reasons for agreement and disagreement.

Chapter 17

Interest, Offence and Penalty

17.1 INTRODUCTION

Law never excuses ignorance, unknown state and lack of knowledge of persons. The law itself never discriminates status of a person. It is equally enforceable to known to unknown and lower level to higher-level persons. In Income Tax Act, it is used similarly except to somebody. Moreover, ITA 2002 overrides other acts except constitution of Nepal. In most of the cases, the ITA has used the term interest and penalty. IBFD mentions, the tax authorities may impose a 'fine' on a taxpayer for late filing of a tax return, for late or non-payment of tax due and other irregularities. Fines are usually levied in the form of a surcharge at a fixed amount or a certain percentage of the amount of tax due. Similarly, 'tax penalties' are generally divided into administrative penalties and

criminal penalties. Administrative penalties take the form of additions to the tax and are assessed as part of the tax. Administrative penalties are generally imposed for tax offences, such as failure to make a timely return or payment, negligence, and making a false return or statement. In case of late payments, the penalty may include interest for the period the tax is in default. Criminal penalties, on the other hand, are enforceable only by prosecution. A prison sentence may be imposed for serious tax fraud or where a taxpayer refuses to pay a monetary penalty imposed upon him for a less serious offence. Moreover, 'tax offences' may be specified in the tax laws covering matters such as late filing, late payment, failure to declare taxable income or transactions, negligent or fraudulent misstatements in tax declarations. Some offences committed in connection with taxation, e.g. perjury or conspiracy to defraud may be punishable under general laws of the country.

17.2 PENALTIES FOR FAILURE TO DOCUMENTATION, FILE OF TAX RETURN AND FILE TRUTHFUL STATEMENTS

Penalties are imposed to those taxpayers who fail to meet the obligation as provided in the Act. Penalty includes failure to documentation, file statement of tax return, file truthful statement and comply with the ITA and its rules. Moreover, these may be divided into seven categories as presented in the following table.

Table 17.1: Penalties for failure to documentation, file of tax return and file truthful statement

<table>
<tr><th>Section</th><th>Failure, false and misleading</th><th>Penalties</th></tr>
<tr><td>117(1)</td><td>Failure to maintain documentation</td><td rowspan="2">Zero point one percent (0.1%) per annum without any entitled deductions and including all amounts required to be included or Rs. 1,000 per year whichever is higher</td></tr>
<tr><td>117(2)</td><td>Failure to file statement of tax returns</td></tr>
<tr><td>117(3)</td><td>Failure to file a statement by withholding agents</td><td>One point five percent (1.5%) per annum of the amount of tax required to be withheld from payments</td></tr>
<tr><td>119(a)</td><td>Failure to comply with the ITA 2002 and its rules</td><td>Amounts equal to 15 percent per annum of the understated tax amounts and outstanding tax</td></tr>
<tr><td>120(a)</td><td>Making false/misleading statement unknowingly or due to carelessness</td><td>50 percent of the underpayment of that tax</td></tr>
<tr><td>120(b)</td><td>Making false or</td><td>100 percent of the underpayment of that</td></tr>
</table>

	misleading statement knowingly or recklessly	tax
121	Knowingly or recklessly aiding or abetting another person including inducing	100 percent of the underpayment of that tax

17.2.1 Failure to Maintain Documentation and File Tax Return [§117(1)]

Taxpayers who fail to proper documentation for an income year for account inspection certification and other required certification and documentation of proof in the type and form as prescribed by the IRD are liable to pay a penalty at the rate whichever is a higher amount between 0.1 percent per annum of the person's assessable income without any entitled deductions and including all amounts required to be included in calculating the person's income for the year or Rs. 1,000 per year.

Similarly, same rules apply to them who fail to file statement of tax returns i.e. within three month after the end of income year.

> **EXAMPLE 17-1** A taxpayer fails to proper documentation having sales turnover of Rs. 7,500,000 with total deduction Rs. 6,500,000. In this circumstance, the taxpayer's penalty is to be calculated as 0.1 percent of Rs. 7,500,000 without any deduction from his income i.e. Rs. 7,500 per annum.

> **EXAMPLE 17-2** A taxpayer fails to proper documentation having turnover of Rs. 950,000 with deduction only salary Rs. 800,000. In this context, the taxpayer's penalty is to be calculated for Rs. 1,000 per annum.

In addition, these penalties are calculated for each month and part of a month to arrive at penalty amount. Thus, if that was for six and half month they are calculated as total penalty divided by total duration of year (360 days) and multiplied by days for penalty.

> **EXAMPLE 17-3** Suppose a person having turnover of Rs. 5,000,000 and profit Rs. 500,000 is going to submit his income on Marg 15 in the assessment year. In this case, his penalty is calculated as Rs. 5,000 divided by 360 days for a year multiplied by 45 days for penalty i.e. Rs. 625.

17.2.2 Failure to File a Statement of Return by Withholding Agent

A withholding agent who fails to file a statement within 15 days after the end of each month in the prescribed manner and form is liable to pay

penalty for each month and part of a month during which the failure continues at 1.5 percent per annum of the amount of tax required to be withheld from payments made by the agent.

EXAMPLE 17-4 A withholding agent reduced tax amount from payment of royalty on Poush in any income year Rs. 15,000 from gross amount of Rs. 100,000 but he withheld this amount on Chaitra 15 in the same income year. In this condition, his penalty is to be calculated as given below:

- Total penalty for the person's 75 days (from Magh 1 to Chaitra 15)
- Rate of penalty at 1.5 percent per annum
- Amount of tax required to be withheld from payments made by the agent Rs. 100,000.

Therefore, penalty is calculated as 1.5 percent of Rs. 100,000 for 75 days based on 360 days in a year i.e. Rs. 312.50.

17.2.3 Penalty for Making False or Misleading Statements

A taxpayer who submits a statement to the IRD that is false or misleading or omits from a statement made to the IRD any matter or thing without which the statement is misleading are liable for a penalty as given below:

(a) If the statement has become false or misleading unknowingly or owing to carelessness that is penalized 50 percent of the underpaid tax; and

(b) If the statement is made false or misleading knowingly or recklessly, 100 percent of the underpaid tax.

Moreover, the statement submitted to the IRD means a statement made in writing to the IRD or an officer authorized by the IRD. This condition may be applied in one or more to the following cases:

- In an application notification, return, objection, statement, or other document prepared, given or filled for the tax purposes;
- Documents, other than those pursuant to the ITA 2002, furnished to the IRD or any officer of the IRD;
- An answer to a question asked to a taxpayer by the IRD or such an officer; and
- Information provided by a taxpayer with appropriate knowledge the details to the IRD or such an officer through another person.

EXAMPLE 17-5 Suppose that a taxpayer submitted a self-assessed statement of income return to the IRO having turnover of Rs. 1,500,000, total of deduction Rs. 1,400,000 and taxable income (taxable base) Rs. 100,000. However, the taxpayer unknowingly deducted same item of expense Rs. 50,000 at two places and it was found by the IRD after 2 years. In this context, the taxpayer has to pay Rs. 6,250 as penalty for this misstatement if effective tax rate was 25 percent for that income year. Moreover, the person also has to pay income tax at the rate of 25 percent and 15 percent per annum of the understated tax amounts and outstanding tax amount for 2 years.

EXAMPLE 17-6 In an income year, a taxpayer intentionally or knowingly submitted an income statement having turnover Rs. 1,700,000 after hiding Rs. 300,000 from its income. If the tax rate was 25 percent for that year then he has to pay Rs. 75,000 as penalty under this provision. In addition, the person also has to pay income tax at the rate of 25 percent and 15 percent per annum of the understated tax amounts and outstanding tax amount.

17.2.4 Penalty for Aiding or Abetting

A person who knowingly or recklessly aids or abets another person to commit an offence: to pay tax, make false or misleading statement, obstructing, be unauthorized person, an accomplice, and comply with Act or counsels or induces another person to commit such an offence is liable for a penalty equal to 100 percent of the underpayment of that tax.

17.3 INTEREST FOR FAILURE TO PAY TAX AND UNDERSTATING ESTIMATION OF INSTALLMENTS

In finance, interest denotes charge or payment while borrowing money or a charge made for a loan or credit facility, or a payment made by a bank or other financial institution for the use of money deposited in an account. In income tax, interests are imposed as use of money by the taxpayer to be paid to the government. Moreover, it also reduces the behavior of non-compliance of taxpayers. Again, it is a kind of remedy for compliance in time with good judgment.

Table 17.2: Interest for understating estimation and failure to pay tax

Section	Understating estimation and failure to pay tax	Interests
118(1)	Understating estimation of tax	15 percent per annum of the

	installments	understated tax amounts and outstanding tax (It is called standard rate for 15 percent in the ITA 2002)
119(1)	Failure to pay tax before the date on which the tax is payable	

17.3.1 Interest for Understating Estimated Tax Payable on Installment

If a taxpayer fails for right estimation or estimates less than 90 percent of the actual payment for the installment the person is liable to pay an interest from standard interest rate for that inadequacy.

EXAMPLE 17-7 A taxpayer estimated taxable income Rs. 400,000 for an income year and paid installments Rs. 40,000; Rs. 30,000 and Rs. 30,000 for first, second and last installments respectively. However, in self-assessment assessed by the taxpayer at the end of Aswin, taxable income reached Rs. 600,000 in which day it has to be submitted in the IRO. In this condition, interest for understated installments is calculated as given below.

Computation of tax liability including interest for understated installments

Taxable income					600,000
Tax rate @ 25%					150,000
Calculation of interest for understated installments					
Installments	Realized	Estimated	Difference	Interest for	Interest
First (40%)	60,000	40,000	20,000	Poush – Asvin	2,250
Second (30%)	45,000	30,000	15,000	Chaitra-Asvin	1,125
Last (30%)	45,000	30,000	15,000	Ashadh - Asvin	562.50
Total	150,000	100,000	50,000		3,937.50
Tax amount including interest					153,937.50
Failure to file estimated installments					-
Additional tax (1.5% of the taxable income Rs. 600,000)					9,000
Tax liabilities					162,937.50
Less: Advance tax (paid in installments)					100,000
Tax payable amount					62,937.50

The interest is always calculated for the period of failure. In above examples, interests are calculated at the rate of 15 percent for the first, second and last for the duration of nine months, six months and three months respectively.

17.3.2 Interest for Failure to Pay Tax or Delay Payment of Tax

If a taxpayer fails to pay tax on or before the date on which the tax is payable is liable to pay a standard interest rate on the amount outstanding for each month and part of a month for which any of the tax is outstanding. Moreover, for calculating interest payable no interest exemptions for the extension are granted.

> **EXAMPLE 17-8** Assume that a taxpayer estimated more than 90 percent of annual tax and made a payment of installment accordingly. However, the taxpayer failed to file statement of income within due date i.e., by the end of Aswin assume that Rs. 10,000 and it submitted at the end of Marg. In this context, if the taxpayer has not extended the submission date the interest is calculated for 2 months.

17.4 PENALTIES FOR VARIOUS OFFENCES

Simply offence is legal or moral crime. It also includes an official crime, or a crime against moral, social, or other accepted standards. Similarly, penalty is a legal punishment for committing crime. It also includes a legal or official punishment such as a fine or imprisonment for committing a crime or other offence. The offences and their penalties are presented in the following table.

Table 17.3: Penalties for various offences

Sec.	Offence	Fine and punishment				
		Fine		Imprisonment		Both
123	Failure to pay tax	Between Rs. 5,000 to Rs. 30,000	or	Between 1 month to 3 months	or	Both
124	Submission of false or misleading statement	Between Rs. 40,000 to Rs. 160,000	or	Between 6 months to 2 years	or	Both
125(1)	Impending and coercing tax administration	Between Rs. 5,000 to Rs 20,000	or	Between 1 month to 3 months	or	Both
125(2)	Who attempts to commit to impend or coerce	Between Rs. 2,500 to Rs. 10,000	or	Between ½ month to 1 and half month	or	both
126(1)	Authorized persons if breaches the official secrecy [§84)	Upto Rs. 80,000	or	Upto 1 year	or	Both
126(2)	Unauthorized persons collecting or attempting	Between Rs. 80,000 to	or	Between 1 year to 3 years	or	Both

	to collect tax	Rs. 240,000	
127	Aiding or abetting to another (if abettor is general public)	Half of the penalty that is imposed on the main offender	
	Aiding or abetting to another (if abettor is Govt. official)	Full penalty that is imposed on the main offender	
128	Failure to comply with the ITA 2002	Between Rs. 5,000 to Rs. 30,000	Fine only

The above table depicts the position of fine and imprisonment for taxpayers. There are two limits except §128 for fine and imprisonment and both of them may be applied. According to principles of equity they are quite unjustifiable according to their flexibility. Two judges of two different places may apply different fine or imprisonment or both for the similar offence and amount of case with a lower limit of fine only, with lower limit imprison only, with lower limit of both or with higher limit of one and with higher limit of both. It encourages corruption or nepotism or favoritism in the society. My thought is that income tax law should always be made in definite for a particular case to some extent. Moreover, these provisions require further study.

17.4.1 Penalty for Failure to Pay Tax [§123]

If any person who without reasonable excuse fails to pay any tax on or before the date on which the tax is payable is to be liable on conviction to a fine of between Rs. 5,000 to Rs. 30,000, or an imprisonment for a term ranging from one month to three months, or both.

> **EXAMPLE 17-9** In an income year, persons ‘A’, ‘B’ and ‘C’ fail to pay tax on or before the date without reasonable excuse. In this condition, they may be penalized by a fine of between Rs. 5,000 to Rs. 30,000 and an imprisonment for a term of between one month to three months or both.

> **EXAMPLE 17-10** Persons ‘X’ and ‘Y’ fail to pay tax on or before the date without reasonable excuse in any income year. In this context ‘X’ may be penalized by a fine of Rs. 5,000 but ‘Y’ may be penalized with a fine of Rs. 5,000 or Rs. 30,000 or Rs. 5,000 and imprison for one month or a fine Rs. 30,000 and imprisoned for three months.

> **EXAMPLE 17-11** Persons ‘M’ and ‘N’ fail to pay tax without reasonable excuse in any income year. Amounts of failure to pay taxes were Rs. 100,000 and 200,000,000 by ‘M’ and ‘N’ respectively. In this circumstance, Judge / tax official has to choose

one alternate among the provisions. However, it may be lower to upper or both.

17.4.2 Offense of Making False or Misleading Statements [§124]

If a person who makes a statement to the IRD that is false or misleading in a particular material or omits from a statement made to the IRD any matter or thing without which the statement is misleading in a particular material has to be liable to a fine of between Rs. 40,000 to Rs. 160,000 or an imprisonment for a term not less than six months and not more than two years, or both.

17.4.3 Offence for Obstructing or Coercing or Influencing Tax Administration (§125)

A person committing the following offences is liable to a fine of not less than Rs. 5,000 and not more than Rs. 20,000 or an imprisonment for a term of not less than one month and not more than three months or both.

(a) If obstructs an officer of the IRD on duty under the Act;
(b) If fails to comply with a notice for obtaining information
(c) If obstructs the enforcement of the Act in any other ways

Moreover, any person if attempts to commit the offences as explained above is liable to half of the penalty as mentioned.

17.4.4 Penalties for Authorized and Unauthorized Persons

If any authorized person violates official secrecy is liable to a fine of upto Rs. 80,000 or an imprisonment for a term of upto one year, or both. Similarly, if any person who is not authorized by the Act collects or attempts to collect tax or any other amounts in the name of tax is liable to a fine of between Rs. 80,000 and Rs. 240,000 or an imprisonment for a term of not less than one year and not more than three years or both.

17.4.5 Offense of Aiding or Abetting (§127)

If any person who knowingly aids or abets another person to commit an offence under the Act or counsels or induces another person to commit such an offence is liable to half of the penalty that is imposed on the main offender.

But, government officials if commit such an offence is liable to full penalty that is imposed on the main offender.

17.4.6 Penalty for Failure to Comply with the Act [§128]

If a person who fails to comply with any provision of the Act and its rules is liable to a fine of not less than Rs 5,000 and not more than Rs. 30,000.

Chapter 18

Tax Administration

Tax administration implies the management of affairs related to tax. A sound system of tax administration is pre-requisite to assess the taxation policies of the government. For the success of tax administration of any government different constituents are established and these plays significant role such as executive, legislative, reporting, auditing etc. In Nepal, the tax administration contains the following facts.

18.1 INLAND REVENUE DEPARTMENT

Inland Revenue Department (IRD), since its inception in 1960 A.D., is chiefly being responsible for the administration of taxes. According to administrative structure established by the Government of Nepal, the

IRD is an executive body of the Government to execute income tax law. The IRD is responsible for the administration and implementation of the provisions of Income Tax Act. It clears that the IRD is a single organization for administering the regulation regarding to Income Tax Act.

To execute norms and values of the law, it has made three tiers administrative structure, including their power and duties by Act, to provide effective and efficient services for taxpayers.

☐ A Director General

The Director General (DG) is the key post of the IRD. Subject to direction from the Government of Nepal it has right to exercise and delegate any power granted to the IRD. However, it can not delegate the power to issue public circulars, compound and offence, prescribe documents and stay or otherwise affect a re-assessable or an objection decision.

☐ Deputy Director Generals in the numbers as may be required, Chief Tax Administrators, Directors, Chief Tax Officers, Tax Officers and other Officers

The above stated posts of IRD are second layer posts. Subject to direction from the Government of Nepal and DG, these have right to exercise any power other than the exclusive power of DG such as issue public circulars, compound and offence, prescribe documents and stay or otherwise affect a re-assessable or an objection decision. But these second layer posts have right to delegate the power granted to them.

☐ Other Staffs

These are the bottom line posts of the IRD. According to the Act these posts may exercise delegated power other than the exclusive power of the DG. However, these cannot authorize power notice to obtain information or issue a notice for recovery of tax from person owing money. These posts are also unable to delegate their power to other persons.

According to the delegated power and structure the tax administration is to provide effective and efficient services, provided the available resources are effectively used for the development of the organization. It is to be committed towards our future directions, which are mentioned in mission, vision, norms and values. This is the basic structure of the IRD.

Mission is the assigned task or a particular task given to a person or group to carry out. Thus, collection of tax revenue by providing fair, efficient and effective services in economic way to the taxpayers in

accordance with the revenue mobilization policies of the Government of Nepal is the primary mission of the IRD.

Vision is the far-sightedness or the ability to anticipate possible future events and developments. Therefore, peaceable revenue collection from fair, efficient and effective income tax system and execution of the law considering the future events is the vision of the IRD.

Norms and values of the IRD are given below:

- Fair and identical treatment to all,
- Work with self-respect without any sort of fear, panic and prejudice in any circumstances,
- Be sensitive to provide services as per the demand of change,
- Be careful towards building professionalism and efficiency in work performance,
- Be devoted towards continuous pursue of new and latest methods to increase the quality of service and to apply them in practice, and
- Work jointly with team spirit by extending mutual cooperation and respect for achieving the goal of the organization.

Goal should be at least to attain the commitments for effective implementation of income tax law including directives of the Government.

Commitment denotes the responsibility for services. Thus, the IRD should be committed at least to do the following:

- To provide high quality service to the taxpayers
- To serve the taxpayers with politeness
- To assure fair assessment through efficient manpower
- To aware of the need for reform in tax administration
- To simplify the procedural requirements for the taxpayers
- To inform complete and clear way to the taxpayers
- To make the tax paying procedure more simple and convenient

☐ Public Circulars

The IRD may issue public circulars relating to tax matters. Especially those circulars contain: guidelines to the tax authorities, interpretation of the Act and notify the facts.

☐ Ruling

Ruling is decisions or opinions of the tax authorities in respect of actual fact situations which come before it as part of an assessment procedure or

in response to taxpayer questions. Such rulings may or may not be published. If the taxpayer wants to enter into a specific tax matters and seeks a predictable and reliable decision with respect to this tax case he can apply in writing to the IRD for a personal ruling. The IRD can issue the personal ruling within 90 days after it has received the taxpayer's application. The personal ruling can not be issued if the tax matter involved is presently being dealt with before a court, or has already been decided by a court. A decision of the Supreme Court always overrides an opinion of the IRD.

18.2 TAXPAYER'S RIGHT

According to John Locke,"Every man has a property in his own person this no body has any right to but himself. The labours of his body, and the work of his hands, we may say, are properly his". Similarly, Rand (n.d.) stated that:

> A right is a moral principle defining and sanctioning a man's freedom of action in a social context. Thus, a person at least reserves 'Right of Life', 'Right to Liberty', 'Right to Property', Right to the Pursuit of Happiness', Right to Free Speech', and 'Right to Self Defense'.

In Nepal, tax law overrides all the laws other than constitution. However, the Constitution of Nepal differentiates people to people classifying different groups of people and it is fully imposed to them who do not know in this earth there is any law to protect unable human. However, ITA 2002, who is under the definition of taxpayer, the Government of Nepal provided to taxpayers to preserve at least the following rights in respect of income taxation.

☐ Right to be Respectful

Tax is an amount of money levied by a government on its citizens and used to run the government and taxpayers are those who pay that tax. Thus, they have right to be treated respectfully.

☐ Right to Get Evidence of Submission

Taxpayers have rights to receive the evidence of receipt immediately after the submission of their tax returns. This strictly reserves right to get the evidence of taxes paid within one hour of the payment. Similarly, taxpayers have right to receive evidences of submission of correspondences or details within one hour of submission.

☐ Right to Get Advance Ruling

Taxpayers have right to receive the decision on Advanced Ruling demanded within three days of taking of such decision and right to get intimation about the status of application (for Advance Ruling) within 15 days.

☐ Right to Adopt Representative

Taxpayers reserve the right to adopt an official or legal representative for the tax purposes at any time.

☐ Right to Get the Copy of Document

Taxpayers keep the right to get the copy of concerned document from an Inland Revenue Office within 24 hours.

☐ Right to Get the Intimation

Taxpayers hold the right to get the intimation of intended re-assessment of the taxpayers and intimation of the decision to be conveyed within three days.

☐ Right to Get Clearance Certificate

Taxpayers grip the right to get a tax clearance certificate within 24 hours after payment of taxes levied according to law.

☐ Right to Get Mobile Service

Taxpayers are provided the right to get mobile service if jointly requested by at least 15 persons from the localities outside the towns with the IROs.

18.3 DUTIES OF THE TAXPAYER

According to ITA 2002 and ITR 2002 the taxpayers and other related or connected person has the following obligation about the income tax.

☐ Individual and Couple [§50]

Each spouse of a resident couple making an option with respect to an income year is jointly and individually liable along with the other spouse for any tax payable by the couple for the year. According to the provision, a married resident couples' each spouse is taxed individually. But the married resident couples may elect to be treated as a couple for a particular income year. If they elects them as a couple, income of both spouse is added into one and their reduction from taxable income for family status threshold applies for couple. Again, if the income of both spouses is calculated separately each spouse can claim the reduction from taxable income for family status and threshold applies individually.

☐ Maintenance of Documents

Every person liable to maintain in Nepal documents of the type, form, and certification prescribed by the IRD including the documents: (1) documents that are necessary to explain information to be provided in a return or in any other document to be filed with the IRD, (2) documents that enable an accurate determination of the tax payable by the person; and (3) documents that substantiate deductions and outgoings. The person has to keep the entire concerned document not less than five years. Moreover, the document which requires maintaining that should be in Nepali.

☐ Form, Place and Time for Payment

Each taxpayer has to pay his tax liability within a time, place and method as prescribed by the IRD. The payment of tax consist payable by withholding, installments and assessment.

☐ Returns of Income

Every person is required to file at the place prescribed by the IRD not later than three months after the end of each income year. A return of income must be with necessary information, format, and required payment of tax liability.

Chapter 19

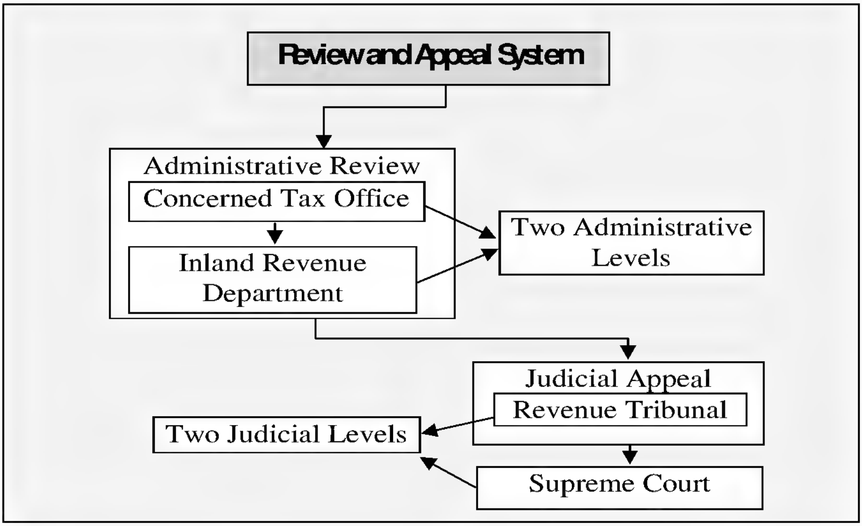
Administrative Review and Appeal

19.1 REVIEW AND APPEAL

ITA 2002 has made provisions regarding review and appeal to assure legal basics. When a person feels over estimation of tax liability to him/her by the concerned tax office or department then a person can use this provision of review and appeal. Especially there are two broad

systems for this purpose of review and appeal. These are: Administrative Review and Appeal.

Figure 19.1: Review and appeal system



19.1.1 Administrative Review [§114(1)]

There are two administrative reviews: Concerned Tax Office and Inland Revenue Department (Appeal Section). Administrative review is conducted to correct the error made by concerned tax office or the IRD after an objection from the taxpayers. Thus, it includes the following:

☐ **Contents of Administrative Review**:

Administrative review consists the following points:

1. **Personal ruling**: If a decision of personal ruling is made by the officer other than Director General this fall under administrative review.
2. **Decision for estimated tax**: Decision made by the IRO to make an amended estimate of tax payable if objected by the taxpayer it can be reviewed by the administrative level.
3. **Decision to file income return**: Decision made by the IRO regarding requirements to file an income return can be reviewed from the administrative level to correct the former decision.
4. **Decision regarding time extension**: Decision made by the IRO in respect for extensions of time to file an income return can also be reviewed from administrative level.

5. **Decision of Penalty and Interest**: Decision made for the amended assessment or jeopardy assessments, penalty and interest born in respect of this assessment can also be reviewed by administrative level.
6. **Decision of Recovery of Tax from Receiver**: Decision of notification by the IRD of an amount to be set aside to be given to someone by a person as a receiver.
7. **Decision of recovery of tax from person owing money**: A decision by the IRD to require a person to pay monies owing to a tax debtor to the IRD can be reviewed.
8. **Decision of the IRD to pay tax on behalf of the non-resident person**: Decision made by the IRD regarding recovery of tax from agent of non-resident can be performed from administrative review.
9. **Decision about refund applications**: A decision made by the IRD on an application by a person for a refund of tax can be reviewed from tax administration.

☐ **Procedure for Administrative Review**

For the purpose of administrative review, taxpayer has to submit an application to the IRD within 30 days of the receipt of notice of decision. If a taxpayer delays to submit an application with reasonable cause the IRD can extend it to next 30 days with the written request of the applicant. The objections of the applicant have to be filed with an application in detail. It may contain the section, rules, circulars, decision of a court, and international precedents. Moreover, a file of application for administrative review requires 50 percent of deposit from the taxpayer.

19.1.2 Appeal to the Revenue Tribunal [§116]

According to Wikipedia, an appeal is the act or fact of challenging a judicially cognizable and binding judgment to a higher judicial authority. In common law jurisdictions, most commonly, it means formally filing a notice of appeal with a lower court, indicating one's intention to take the matter to the next higher court with jurisdiction over the matter, and then actually filing the appeal with the appropriate appellate court.

A taxpayer who is aggrieved by a decision made by the IRD on an application may appeal to the Revenue Tribunal in accordance with the Revenue Tribunal Act, 1974.

According to law, a taxpayer who is not satisfied with the assessment made by a tax officer and the application against the assessment rejected by the IRD due to expiry of 60 days (including the extension period) or

disallowed by the IRD then the person can appeal to the Revenue Tribunal against the decision. For the appeal, an applicant should deposit an amount equal to a sum of 50 percent of the tax assessed by the tax officer including penalty imposed to the applicant. Moreover, an appeal to Revenue Tribunal has to be filed within 35 days from the receipt of assessment order by the taxpayer.

19.1.3 Writ Petition to Supreme Court

In jurisdictions a 'writ' is an order from a higher court to a lower court or to a government official. Especially writ is used for two cases: human rights and principles gap in law.

When the taxpayer or the tax office is not satisfied with the decision of Revenue Tribunal, s/he can file a writ petition to Supreme Court for further decision. However, the writ petition must be permitted to file the writ petition.

PART

3

Value Added Tax in Nepal

Chapter 20

Value Added Tax in Nepal

20.1 CONCEPT OF VALUE ADDED TAX

Taxes are the most important and reliable sources of government revenue. Specially, on the basis of place of payment of taxes, these are either direct or indirect. Income tax, property tax, gift tax etc. are direct taxes and sales tax, value added tax (VAT), amusement tax etc. are examples of indirect taxes. Among the indirect tax, VAT is the most recent innovation in the field of taxation. Now-a-days, it has played significant role to raise revenue for the government. Because it is taxed on expenditure and it ultimately affects final consumers.

The tax which effects final consumer is also known as a consumption tax and consumption tax is also known as an expenditures tax, consumed-income tax, or cash-flow tax; is a tax on what people spend instead of what they earn. Al Ehrbar (n.d.) describes that a VAT does that in the same way as sales tax does. But a true consumption-tax system would entail something much different from simply layering a VAT on top of the current income tax. One way to think of a consumption-tax system is simply as an income tax that allows unlimited deductions for savings and that taxes withdrawals from savings, much like independent retirement accounts.

VAT is a new innovation of 19^{th} century. It belongs to the family of sales taxes. But, it is quite different from sales tax by its burden. A general sales tax is a tax on sales transactions and is applied only at one stage of business activity while VAT is a multi-stage tax and is applied at all levels of transactions of business activities.

A concept of VAT was developed to overcome the difficulties in conventional system of commodity taxation. VAT means "Value Added Tax", which means that the tax is payable only on value added at each stage and not on the gross sales price.

Value added of a firm is the difference between a firm's sales and a firm's purchases made from all other firms. In other words, (Bickley, 2004:1) a firm's value added is simply the amount of value that a firm contributes to a goods or services by applying its factors of production (land, labor, capital, and entrepreneurial ability). A value added tax would be a tax, levied at each stage of production, on a firm's net value added.

> **EXAMPLE 20-1** If 'B' purchases goods from 'A' at Rs. 110 and sells the same to 'C' at Rs. 150, the value added by B is only Rs. 40 and hence under the VAT scheme, the tax would be payable by 'B' only on Rs. 40.

VAT works on the principle that when raw material passes through various manufacturing stages and manufactured product passes through various distribution stages, tax should be levied on the 'Value Added' at each stage. This ensures that same commodity does not get taxed again and again and there is no cascading effect. In simple terms, 'value added' means difference between selling price and purchase price. Basically, it is multi-point tax, with provision for granting credit of the tax paid at the earlier stage. Thus, tax burden is passed on when goods are sold. This process continues till goods are finally consumed. Thus, it is termed as consumption type tax and works on the principle of 'tax credit system'.

Figure: 20.1 Representation of value added tax

	Basis	Represents
Value Added Tax	Form	Indirect tax
	Rate structure	Proportional tax / Flat tax
	Nature of tax	Consumption tax
	Essence	Ad valorem tax
	Volume	Multiple tax group

VAT is an indirect tax. Specially, there are two main types of indirect taxes such as specific and Ad valorem. A specific tax is that where the amount charged is always the same on each unit. An ad-valorem tax, by contrast is one where the tax is charged as a percentage of the value of goods. This is where it comes in, as it is always 13% of the value of goods represents a proportional tax on the basis of rate structure too.

United Nations, Commission of the European Community (1993) defines that:

> A tax on goods or services collected at stages by enterprises but which is ultimately charged in full to the final purchasers. It is described as a "deductible" tax because producers are not usually required to pay to the government the full amount of the tax they invoice to their customers, being permitted to deduct the amount of tax they have been invoiced on their own purchases of goods or services intended for intermediate consumption or fixed capital formation. VAT is usually calculated on the price of goods or services including any other tax on products. VAT is also payable on imports of goods or services in addition to any import duties or other taxes on the imports.

The Columbia Encyclopedia (2001) states:

> Levy imposed on business at all levels of the manufacture and production of goods or services and based on the increase in price or value, provided at each level. Because the consumer ultimately pays a higher price on taxed commodity, a VAT is essentially a hidden sales tax.

VAT is a general consumption tax assessed on the value added to goods and services. Thus, the above definition generalized the following facts:

1. VAT is imposed on business at all levels of transactions. It means it is imposed at every level of transaction such as manufacturer, wholesaler, and retailer at their selling price.
2. It is based on the increase in price or value provided at each level. It means it is imposed on respective increased value of the expenses or

profit margin. The value added denotes difference in sales and purchase.

3. VAT levy, which is imposed on various levels of transactions, is indirectly collected from final consumer. Anyone involved in merchandised functions are only intermediaries of the transactions, so they do not pay themselves that tax because in every transaction they collect tax from their sales. Thus, the burden of tax falls under the consumption of final customers.

20.2 ORIGIN AND DEVELOPMENT OF VAT

In taxation history, VAT is the latest emerging indirect tax. In 2000, Caldwell affirms that VAT has its theoretical origin in the United States of America. The concept was evidently first proposed by Professor T. S. Adams, who discussed the concept in papers published during the period 1911-21. It was promoted in 1918 by the German industrialist Wilhelm von Siemens. In 1919, Siemens recommended to introduce this multistage turnover tax in Germany to avoid undesirable effects. The government was serious but did not introduce this tax considering its complications. But, the government of Germany reduced the tax rate of other taxes instead of introducing the VAT. "One year later, other proposals of VAT emerged in France in 1920s; the recognizable VAT did not appear until to 1948" (IMF, 2002). In 1949, the Japanese scholar Shoup also recommended the VAT for reconstruction of Japanese economy however it did not come into practice.

Caldwell (2000) declares that it was considered for several decades until it was implemented in Michigan in 1953. One year later, France adopted the VAT in 1954. In France it was limited on industrial sector and wholesale level of the transactions. In addition, its edge of application was limited within the territory of France. In a short period of time, since the decade of sixties, the countries took speed to introduce the VAT considering its significant result of indirect taxes revenue. After 6 years, in 1960, Ivory Coast pursued France by adopting VAT. Similarly, Senegal introduced it in 1961. A Latin American country Brazil and a European country Denmark introduced VAT together in 1967.

The European Union (EU) formed a VAT directive in April 11, 1967 which required Member States to replace their general indirect taxes by a common system of VAT. Among EU countries, the Federal Republic of Germany introduced it in January 1, 1968 while the first proposal of VAT was also originated in this country. In 1968, France, the first country to introduce VAT, extended the VAT to retail level.

VAT directive of EU impacted all over the world and thus 20 counties introduced the VAT principles since 1970 to 1979. In UK, it was applied in 1973 replacing its existing sales tax. So far, (at http://www.indiamart.com/) 21 OECD countries out of 24, have implemented VAT with the exception of the US, Switzerland and Australia. Similarly, the number of countries introducing VAT since 1980 to 1989 was 20. While in the early nineties, the number of countries introducing the VAT increased at galloping style and reached 49 countries from 1990 to 1995.

Neighboring countries of Nepal i.e., China and India introduced the VAT in October 1, 1984 and March 1, 1986 respectively. Again, China replaced VAT on 24 specified taxable items mentioned in VAT 1984 with more advanced form of VAT in January 1, 1994. However, VAT of India is a developed Central Sales Tax therefore called as a Modified VAT (MODVAT). In India, (at http://www.indiamart.com/) the MODVAT scheme was replaced by a new set of rules called Central Value Added Tax (CENVAT) Credit Rules 2002. Nepal also adopted VAT as an instrument of tax harmonization in 1997 and it is now a foremost part of the tax structure of the State. At present (at http://www.indiamart.com/) VAT is implemented in more than 123 countries around the world. It covers over 70 percent of the world's population and raises nearly 27% of total tax revenue in those countries.

20.3 DEVELOPMENT OF VAT IN NEPAL

VAT is the newest form of indirect tax of Nepal. It replaced sales tax, hotel tax, entertainment tax etc. which traditionally existed in Nepal. After the restoration of democracy in 1947, the democratic government adopted open market system and came into new technology about this system. Khadka (2001) writes, in Nepal, the tax system was ineffective and non-transparent according to its pace of development according to the VAT envisioned in eighth five-year-plan. In 2051, Ministry of Finance constituted a "taxation review taskforce" and the taskforce presented a report in Jestha 2052 which states significant role of VAT and its necessity of introduction (Report, 2052) in Nepal.

To introduce the VAT in Nepal, a "VAT taskforce" organized in 2052 under the financial and technical co-operation of USAID and Harvard University, USA respectively. This taskforce evaluated a variety of circumstances concerning tax structure; VAT operation and economic condition of the country and drafted VAT legislation as a multistage tax instead of single stage tax like sales tax, hotel tax, contract tax and amusement tax. Government of Nepal presented this VAT legislation as a VAT bill in parliament for adequate discussion on session. It was

passed after discussion by both House of Representative and National Assembly of parliament in Poush 2052 and Royal Sealed on it in Chaitra 7, 2052. After the completion of VAT Act 2052, then VAT rules 2059, was carried out in 2059. The VAT of Nepal started since Marg 1, 2054 under certain threshold.

20.4 TYPES OF VALUE ADDED TAX

Especially there are two important variant of VAT. However, these may be split into the four variant of VAT. Caldwell (2000), Musgrave and Musgrave (2004), Choudhary (2002) have included three variant of VAT while Lekhi (2002) has included four variant of VAT. The former scholars assert GNP type, income type and consumption type VAT. The later one has included additional one variant of VAT i.e., wage type value added tax. The difference between these emerges from the treatment of capital and depreciation when a firm is allowed to deduct the credit.

20.4.1 Consumption Type

The consumption type VAT is equivalent in base to a retail sales tax that exempts all purchases for business use including capital equipments. In other words, the firm is allowed to deduct not only non-capital inputs purchased from other firms but also the capital equipment so purchased in consumption type VAT. Most of the European countries have adopted this type of VAT by the reason that the firms are allowed for depreciation in capital equipment, they tend to apply high rates of depreciation. Consumption type is also simple to estimate. It is also called subtractive type VAT.

20.4.2 Income Type

Under the income type VAT, the tax is imposed not only on the output of consumption goods but also on the net-of-depreciation value of capital goods purchased by the firm. In other words, the firm is allowed to deduct the full value of its non-capital purchases from other firms under the income type VAT. It is also called additive type VAT.

20.4.3 Gross National Product Type

Under the gross national product type, the firm is not allowed to deduct anything except the value of non-capital purchases. In addition, no depreciation is allowed to be deducted on account of purchase of capital goods even in the subsequent years. As a result, the base of the tax is total value of consumption goods plus all final product capital goods. Finland, Morocco and Senegal have applied this type of VAT.

20.4.4 Wage Type

Under this type of VAT, a firm is able to deduct the net earnings from its capital in order to get the base of tax. Thus, net earnings of the firm are equal to the net profits which include interest of firm's own profit. Firm's capital for that particular year points out net income of the firm for that year that is equal to gross national income of the firm minus the depreciation in that year.

EXAMPLE 20-2 A sample computation of the various types of VAT is depicted in the following table. The tax base of the consumption type is computed for each firm by taking total sales receipts and deducting the purchase of intermediate and capital goods. The tax base of income type is computed for each firm as sales minus the cost of intermediate goods and depreciation. The tax base of GNP is computed for each firm as finally equal total sales minus the purchase of intermediate goods. At last, adding the bases for the three firms, we obtain the base for the entire economy.

Table 20.2: VAT bases for various variant of VAT

Particulars	Firms			Economy
	A	B	C	
Current receipts				
1. Sale of consumer goods	--	70	151	221
2. Sale of intermediate goods	120	45	--	165
3. Sale of capital goods	--	100	--	100
4. Total	120	215	151	
Current costs				
5. Wages, interest, profits, etc.	100	80	90	270
6. Purchase of intermediate goods	--	120	45	165
7. Depreciation	20	15	16	51
8. Total	120	215	151	
Capital costs				
9. Purchase of capital goods	--	--	100	100
Tax base				
10. Consumption type (4-6-9)	120	95	6	221
11. Income type (4-6-7)	100	80	90	270
12. GNP type	120	95	106	321
National accounts				
13. Consumption				221
14. Plus investment				100
15. GNP				321
16. Minus depreciation				51
17. National Net Product (NNP) or National Income (NY)				270

20.4.5 Rule to Distinguish Each VAT

A general rule for distinguishing different varieties of VAT is based upon the treatment of fixed investment expenditure. In consumption type, fixed investment is fully deducted from gross value of output. In production type no deduction for fixed investment is made from gross value of output. In income type, depreciation of fixed investment is deducted from gross value of output. And in wage type, the estimate of income type is further reduced by deducting profit and interest.

20.5 METHODS TO ADMINISTER THE VAT

There are three methods used for computing a VAT, so that the tax is on the net value added by the firm and no pyramiding takes place. Caldwell (2000) asserts these two methods are the tax credit method and the calculation method. Both methods produce the same tax on the firm but they are administered differently. However, other writers add another computation method in addition to this.

20.5.1 Calculation Method

In the calculation method, the VAT is not openly shown on each transaction. The firm just computes the difference between its total sales and total purchases i.e., the value added and applies the VAT rate to its difference. It is also called subtraction method. It takes place as hidden tax, like an income tax. Thus, the customer is unaware of payment of tax. This method is more beneficial from the government's point of view because citizens are not frequently reminded of the burden of tax.

This calculation method of VAT is appropriate if it is applied with a single VAT rate to all products. The firm calculates the total value added by subtracting its purchase from its sales and the VAT is determined by multiplying the VAT rate times the value added. The firm does not require huge manpower and skill to get the result periodically. It may be obtained daily, weekly, bi-monthly or monthly as required. The calculation method may be symbolically understood as:

$$VAT = (TS-TP)Tr$$

Where, VAT = value added tax
TS = total sales
TP = total purchase
Tr = multiplier tax rate

EXAMPLE 20-3 A firm dealt the business under single tax rate i.e., 10 percent on different products. The total of purchase during the period was Rs. 500,000 and the sales Rs. 750,000. VAT due to

government is determined by subtracting the total amount of purchase from the total amount of sales (Rs. 750,000-Rs. 500,000) and multiplied by the VAT rate (Rs. 250,000 × 10%).

Thus, calculation method is simple and economy to the firm and government too.

20.5.2 Tax Credit Method

Tax credit method is also known as invoice method. It is appropriate when there are multiple VAT rates. Under this method, different VAT rates can be applied in accordance to its significance such as (Caldwell, 2000) the majority products have a standard rate, but some (for example, luxuries, harmful, and narcotic products) may have a higher rate and some (for example, necessities, such as medicines) may have a lower rate or if possible it may be zero-rated. In tax credit method, the amount of the VAT charged on each item is shown on sales invoice. The firm first determines the total VAT charged on all of its sales by adding up all of the VAT amounts charged by it on invoices or sales receipts to its customers which is also called the gross tax. After that, the firm determines the total VAT that is included in all its purchases, by adding up all of the VAT amounts on invoices for its purchases from other firms which is called the tax credit. To obtain the amount of net VAT which is VAT due to the government, the tax credit is subtracted from gross VAT. The tax credit method may be symbolically understood as:

VAT = tSP-tPP

Where, VAT = value added tax

tSP = tax on selling price (adding each item)

tPP = tax on purchase price (adding each item)

EXAMPLE 20-4 A firm dealt the business under different VAT rates. The products were majority, luxury, and basic and if their VAT rates were 15, 10 and 5 respectively.

Product	Buying cost	VAT paid	Selling price	VAT collection
Majority	15,000	2,250	20,000	3,000
Luxury	10,000	1,000	12,500	1,250
Basic	5,000	250	6,500	325
Tax credit		**3,500**	**Gross tax**	**4,575**

Under the tax credit method, tax credit is subtracted from gross tax (Rs. 4,575-3,500) and VAT due to government (Rs. 1,075) is determined.

Thus, tax credit method is useful to them where the government applies different tax rates on different products.

Under the tax credit method, the VAT due to the government from various operation channels is followed as given below.

EXAMPLE 20-5 Manufacturer manufactures goods that it sells to Wholesaler at Rs. 100. Its only inputs are labors and Rs. 10 of raw materials on which Rs. 1 VAT is paid (assume a VAT rate of 10%). The output tax charged by manufacturer is Rs. 10 (Rs. 100 × 10%) and the input tax allowed as a credit is Rs 1. Thus, manufacturer's net VAT liability is Rs. 9.

Wholesaler sells the goods to retailer at Rs. 200. Besides the goods themselves, the only input of wholesaler is labour. The output tax charged by wholesaler is Rs. 20 (Rs. 200 × 10%) and the input tax allowed as a credit is Rs. 10. Thus, wholesaler's net VAT liability is Rs. 10.

Retailer sells the goods to consumer "A" at Rs. 300. Besides the goods themselves, the only input of retailer is labour. The output tax charged by retailer is Rs. 30 (Rs. 300 × 10%) and the input tax allowed as a credit is Rs. 20. Thus, retailer's net VAT liability is Rs. 10. The total VAT collected on supply and distribution of the goods to the end user is Rs. 30.

The tax authorities receive 30 in total, 10 from manufacturer, Rs. 10 from wholesaler and 10 from retailer. This reflects the value added by the all channels.

EXAMPLE 20-6 Further, assume that consumer "A" is also a trader registered for VAT and buys the item from retailer for 300 plus VAT. However, Consumer "A" now later retailer is unable to sell the goods for a profit, and instead sells them to another private customer, "B", for 280 plus VAT.

Later retailer therefore pays Rs. 330 for the item. The later retailer sells the item to consumer "B" for Rs. 280. The sale is subject to VAT at 10 percent, so the later retailer must add this to the price. Consumer "B" therefore pays Rs. 308. The later retailer is entitled to be paid back for the VAT paid out to former retailer, so retains the full Rs. 28 VAT collected. Further, the later retailer is due a rebate of 2 against other sales. The later retailer will therefore claim a refund of Rs. 2 from the tax authorities.

20.5.3 Addition Method

The addition method of computing the VAT base is to sum the firm's payments of wages, salaries, interest, rent, and profits. These payments symbolize the firm's contribution to the value of the economy's output in the period, or its "value added." This base multiplied by the tax rate indicates the amount owed by the government in value added taxes. The addition method of value added tax is also known as the direct method.

> **EXAMPLE 20-7** A firm dealt the business under the single tax rate i.e., 10 percent on various products. The total of purchase during the period was Rs. 200,000 and incurred cost for wages, rent, and interest, if were, Rs. 50,000, Rs. 20,000 and Rs. 30,000 respectively. The profit was determined 10 percent on its cost. In this event, the value added by the firm becomes Rs. 130,000 (Rs. 50,000 + Rs. 20,000 + Rs. 30,000 from wages, rent and interest respectively and profit Rs. 30,000). Under the addition method VAT due to government is determined by multiplying 10 percent on the added value i.e., Rs. 130,000.

20.6 MERITS AND DEMERITS OF VAT

VAT is a consumption tax. The burden of tax falls on the consumer. Most of the countries of the world have chosen to apply VAT; however, it contains the following merits and demerits.

20.6.1 Merits of the VAT

The VAT has the following merits.

☐ **Complete Information**

It provides complete information about each stage of production and sales.

☐ **Difficult to Evade**

It is easier to enforce than sales tax if the country has adopted good accounting norm whereas sales tax can easily be evaded by not reporting to the Revenue Department.

☐ **Collection of VAT**

It is collected from all sectors such as imports, manufacturing, wholesale and retail. Therefore, it is more wide-ranging and fair taxation system whereas sales tax is usually levied only at one stage of the whole chain of marketing.

☐ **Broad Tax Base**

It involves a broad tax base. So, it helps countries to raise more revenue since many countries choose to apply it.

☐ VAT Avoids Cascading Effect

Under VAT each input is taxed only once. It, therefore, avoids cascading, unlike excise and sales taxation, and thereby encourages manufacturing and exports.

20.6.2 Demerits of VAT

The VAT has the following demerits.

☐ VAT Ignores Basic Principles of Taxation

VAT ignores the basic principle of taxation such as ability to pay. So, it is a regressive taxation system. Thus, a number of countries have, however, exempted basic necessities, particularly food items, from VAT in order to compensate its regressive effect.

☐ VAT Requires Good Record Keeping

VAT requires good record keeping of invoices at each stage of production and sales. In case of weak record keeping it brings complication to both buyers and sellers in finding compliance.

☐ Many Loopholes for Evasion

Although VAT contains many loopholes for tax evasion, taxpayer can apply the following methods for VAT evasion.

(a) The taxpayers can use fake invoices to claim tax credit,
(b) There is strong possibility of use of invoices which they received for personal purchase to claim tax credit,
(c) It enables buyers and sellers to strike secret deals regarding issuance of receipts,
(d) The taxpayers can report over sales of zero rated goods.

CASES AND SOLUTIONS

If known foremost channel's cost without VAT

1. An importer purchased a cooler at a cost of Rs. 20,000. No VAT was paid on its import. This item passes through two intermediaries: wholesaler and retailer before reaching consumer. The importer,

wholesaler and retailer incurred Rs. 400 expenses and charged 5 percent profit on cost.

Required:

(a) Cost price to consumer

(b) VAT charged at each level of sales [3+3]

[MBS, 2059 new course TU, modified]

Solution:

Calculation of cost price of consumer and VAT charged by the businessperson in each state

Purchase price of the importer excluding VAT Rs. 20,000			
Channels	Importer to Wholesaler	Wholesaler to Retailer	Retailer to Consumer
Cost price excluding VAT	20,000 ⇩	21,420	22,911
Added value	400+ 1,020 =1,420	400+ 1,091 =1,491	400+1,166 =1,566
Selling price excluding VAT	21,420	22,911	24,477
VAT rate 13%	2,785	2,978	3,182
Selling price including VAT	24,205	25,889	⇘ 27,659
VAT payable	2,785	193	204
Cumulative amount of VAT to the Government	2,785 (2700+0)	2,978 (2785+193)	3,182 (2978+204)

Conclusions:

1. Cost price to consumer is Rs. 27,659
2. VAT paid to Government at each level of sales is:
   (a) Importer collects Rs. 2,785 and the same amount pays to Government.
   (b) Wholesaler pays Rs. 193 (where he collects Rs. 2,978 and deducts Rs. 2,785)
   (c) Retailer pays Rs. 204 (where he collects Rs. 3,182 and deducts Rs. 2,978)
   (d) Total VAT collection by the Government from the transaction is Rs. 3,182.

If known consumer's cost price or
Retailer's selling price including VAT

2. An importer imported a VCR from Japan. No VAT was paid on it. This item passes to the consumer through two intermediaries i.e., wholesaler and retailer. The consumer paid Rs. 20,215 net for this item. All businesspersons charged 7% profit on their cost price.

Required:

(a) Cost price to importer

(b) Value added tax at each level of sales. [3+3]

[MBS, 2060 new course TU, modified]

Solution:

Calculation of imported price of importer and VAT charged by the businessperson in each state

Cost price of the consumer including VAT Rs. 20,215			
Channels	Importer to Wholesaler	Wholesaler to Retailer	Retailer to Consumer
Cost price excluding VAT	14,603 ⇦	15,625	16,719
Added value	1,022	1,094	1,170
Selling price excluding VAT	15,625	16,716	17,889
VAT rate 13%	2,031	2,173	2,326
Selling price including VAT	17,656	18,892	⇧ 20,215
VAT payable	2,031	142	153
Cumulative amount of VAT to the Government	2,031	2,173	2,326

Conclusions:

1. Cost price to importer is Rs. 14,603 (if it is assumed as similar profit to others).
2. VAT paid to Government at each level of sales is:
   (a) Importer collects Rs. 2,031 and same amount pays to the Government
   (b) Wholesaler pays Rs. 142 (where he collects Rs. 2,173 and deducts Rs. 2,031)
   (c) Retailer pays Rs. 153 (where he collects Rs. 2,326 and deducts Rs. 2,173)
   (d) Total VAT collection by the Government from the transaction is Rs. 2,326.

If known amount of consumer's VAT or VAT collected by the retailer

3. An importer imported certain goods. No VAT was paid on it. This item passes to the consumer through a retailer. The consumer paid Rs. 2,420 VAT on this item. Both intermediaries charged 10 percent profit on their cost.

Required

(a) Imported price to importer

(b) VAT at each level of sales [2+4]

[MBS, 2058 new course TU, modified]

Solution:

Calculation of imported price of importer and VAT charged by the businessperson in each state

VAT paid by the consumer Rs. 2,420		
Channels	Importer to Retailer	Retailer to Consumer
Cost price excluding VAT	15,385	16,923
Added value	1,538	1,692
Selling price excluding VAT	16,923	18,615
VAT rate 13%	2,200	2,420
Selling price including VAT	19,123	21,035
VAT payable	2,200	220
Cumulative amount of VAT to the Government	2,200	2,420

Conclusion:

1. Imported price of the importer is Rs. 15,385
2. VAT paid to the Government at each level of sales is:
   (a) Importer collects Rs. 2,200 and same amount pays to the Government
   (b) Retailer pays Rs. 220 (where he collects Rs. 2,420 and deducts Rs. 2,200)
   (c) Total VAT collection by the Government from the transaction is Rs. 2,420.

4. A dealer imported a refrigerator from India paying VAT to the government. The refrigerator passes to the consumer through two intermediaries i.e., wholesaler and retailer. Each businessman incurred expenses of Rs. 1,000 before selling it to their customers at a profit of 15% on sales price. The consumer paid Rs. 5,000 VAT on this item.

Required:

(a) Cost price to importer
(b) Amount of VAT at each level of sales [3+3] [2062 MBS TU]

Solution:

Calculation of imported price of dealer and VAT charged by the businessperson in each state

VAT paid by the consumer Rs. 5,000			
Channels	Importer to Wholesaler	Wholesaler to Retailer	Retailer to Consumer
Cost price excluding VAT	21,047.69	25,938.46	31,692.31
Added value	3,890.77 +1,000	4,753.85+ 1,000	5,769.23 +1,000
Selling price excluding VAT	25,938.46	31,692.31	38,461.54
VAT rate 13%	3,372	4,120	5,000
Selling price including VAT	29,310.46	35,812.31	43,461.54
VAT payable	2,736.2+635.8	748	880

Cumulative amount of VAT to the Government	3,372	4,120	5,000

Conclusions:

1. Cost price to importer is (Rs. 21,047.69+Rs. 1,000) Rs. 22,047.69
2. VAT paid to the Government at each level of sales is:
   (d) Importer collects Rs. 3,372 and he pays Rs. 2,736.20 at custom office and Rs. 638.80 at VAT office of the Government.
   (e) Wholesaler pays Rs. 748 (where he collects Rs. 4,120 and deducts Rs. 3,372)
   (f) Retailer pays Rs. 880 (where he collects Rs. 5,000 and deducts Rs. 4,120)
   (g) Total VAT collection by the Government from the transaction is Rs. 5,000.

REVIEW QUESTIONS AND CASES

1. Examine the Value Added Tax. To what extent it differs from sales tax?
2. Evaluate Value Added Tax. Give its merits and demerits.
3. Explain Value Added Tax in Nepalese context.
4. "Tax credit method of VAT is more suitable for Nepal." Explain with examples.
5. "Effectiveness of Value Added Tax depends on the consciousness of the VAT payers." Evaluate this statement.
6. Critically evaluate VAT system of Nepal.
7. The cost price of a Refrigerator to an importer is Rs. 15,000. No VAT was paid on it. This item passes through a retailer before reaching consumer. Both the intermediaries – importer and retailer – incurred further expenditure of Rs. 500 and Rs. 600 respectively. The three percent profit margin on their cost price is charged by both the intermediaries.

Required:

(a) Cost price to consumer
(b) VAT paid to government at different level of sales. [3+3]

[Model, 2057 MBS TU, modified]

8. An importer imported certain goods. No VAT was paid on it. This item passes to the consumer through a retailer. The consumer paid Rs. 2,420 VAT on this item. Both middlemen charged 10% profit on their cost.

Required

(a) Cost price to importer
(b) VAT at each level of sales [2+4] [2058 MBS TU, modified]

9. An importer purchased a cooler at a cost of Rs. 20,000. No VAT was paid on its import. This item passes through two intermediaries, wholesaler and retailer before reaching consumer. The importer, wholesaler and retailer incurred Rs. 400 each for administration expenses and charged five percent profit on their cost.

Required

(a) Cost price to consumer [3]
(b) VAT charged at each level of sales [3] [2059 MBS TU, modified]

10. An importer imported a VCR from Japan. No VAT was paid on it. This item passes to the consumer through two intermediaries i.e. wholesaler and retailer. The consumer paid Rs. 20,215 net for this item. Both intermediaries charged 7% profit on their cost price.

Required

(a) Cost price to importer [3]
(b) Value added tax at each level of sales [3] [2060 MBS, TU, modified]

11. A consumer purchased a Micro-oven from a retailer paying Rs. 22,000 inclusive VAT. Two middlemen i.e. wholesaler and retailer were involved in this deal. Both of them charged a profit margin of seven percent and ten percent respectively on their cost price. The importer has not paid VAT on its import.

Required:

(a) Cost price to importer. [3]
(b) VAT collected by the government at each level of sales [3] [2061 MBS TU]

12. A dealer imported a refrigerator from India paying VAT to the government. The refrigerator passes to the consumer through two intermediaries i.e., wholesaler and retailer. Each businessman incurred expenses of Rs. 1,000 before selling it to their customers at a profit of 15% on sales price. The consumer paid Rs. 5,000 VAT on this item.

Required:

(a) Cost price to importer
(b) Amount of VAT at each level of sales [3+3] [2062 MBS TU]

13. A film distributor imported a film reel from India. It was 3,000 meters long and price was Rs. 50 per meter in Indian currency. The custom duty for Nepal was Rs. 8 per meter. The other charges of customs were local development fee and special fee each

constituting 1.5 percent on cost. The VAT imposed at the rate of 13 percent on total costs. When the distributor clears dues at Custom Office it handed over to a cinema hall adding 10 percent profit on the cost price. The cinema hall collects Rs. 90,000 VAT from through film.

Required

(a) Selling price of distributors [3]

(b) VAT paid at custom office [3]

14. A Government office received grant from ADB to overview feasible site for producing hydro-electricity. The Government office contracted with AB consultancy for this project Rs. 5,000,000 including VAT. 50 percent contract of consultancy AB handed over to BC, a sub-contractor. The sub contractor makes 10 percent profit on its selling price. The AB consultancy losses 20 percent on its selling price excluding VAT. Where 25 percent cost of AB was free from VAT whereas the cost of BC was fully taxable.

Required

(a) Cost of the sub-contractor

(b) Total cost of the contractor

(c) VAT collected by each party [2+2+2]

15. A customer purchased a UPS from a retailer paying Rs. 38,000. In the transaction, there are two middlemen – wholesaler and retailer. They charged 10% profit on their respective cost price. The applicable VAT rate is 13%.

Required:

(a) Cost price of wholesaler

(b) Amount of VAT paid by the wholesaler

(c) VAT collected by the government at each level of sales [2+2+2]

16. An importer imported LCD Television from Korea paying Rs. 5,000 more VAT to the government on its cost price. The LCD Television passes to the consumer through two middlemen: wholesaler and retailer. Each businessperson incurred expenses of Rs. 2,000 before selling it to their customers at a profit of 10% on sales price. The final consumer paid Rs. 35,000 VAT on this item.

Required:

(a) Imported price of importer

(b) Amount of VAT at each level of sales [3+3]

PART

4

Tax Planning

Chapter 21

Tax Planning

21.1 INTRODUCTION

George Harrison has written a satirical proverb for tax presenting its omnipresent character as:

> If you drive a car, I'll tax the street,
> If you try to sit, I'll tax your seat,
> If you get too cold, I'll tax the heat,
> If you take a walk, I'll tax your feet.
> 'Cause I'm the Taxman and you're working for no one but me.

Exactly taxes follow people or organizations in every moment in every day. Suppose that if anyone buys a cup of tea, some sort of value added tax almost certainly is included in the amount paid. Similarly if anybody makes a telephone call a service tax is imposed in addition to value

added tax. Income taxes are imposed on employment, business and investment. Gain tax is taxed on net gain from disposal of assets and liabilities. Karayan and Swenson (2004) write that taxes seem to be everywhere may be that taxes are a price paid for government. Not the total price: to some extent governments support themselves by charging users for specific services provided. For example, some local governments charge a monthly fee to owners of residences which are hooked up to municipal sewer systems. However, throughout the world governments primarily are financed through taxation. Taxes are charges, not directly related to good or services provided, which are imposed on people and organizations located within a government's legal reach.

In recent studies, Karayan and Swenson confirms taxes may seem to be everywhere, and triggered by a bewildering array of activities, but how is knowledge of taxation and tax planning important to people who do not devote their lives to tax consulting? Sometimes taxation, and thus tax planning, is one of the most important success factors in making a good decision. In addition, tax planning often represents a significant part of doing business. In some cases, taxes are one of the most important aspects in structuring a transaction.

Taxes are only one of the many factors which people and organizations consider when making decisions. In some case, taxes are a dominant factor; in others, tax considerations play a minor part. Good decision makers generally seek to manage taxes on every transaction. One way to measure how well a firm is managing its taxes is to look at its effective income tax rate. A firm's effective tax rate is the sum of total taxes paid by the firm, divided by its (before-tax) net income. Thus, every people or organization always wants to reduce his share of tax from his income by either making planning or without tax planning. Tax planning is the device to reduce tax liabilities to increment after tax earning but other than this is taken into account as crime to reduce tax liabilities.

Tax is a complex phenomenon. It requires many procedures to be completed. Considering this reality of form and nature of taxation, many economists have degraded the principles of taxation. Many taxpayers and scholars have aggressively devalued to the tax principles. "The collection of any taxes which are not absolutely required, which do not beyond reasonable doubt contribute to the public welfare, is only a species of legalized larceny" (Calvin as cited in Hansen, 2004). "When, a new source of taxation is found, in practice, that an old source is abandoned. It merely means that the politicians have two ways of milking the taxpayer where they had only one before" (Mencken). Similarly other

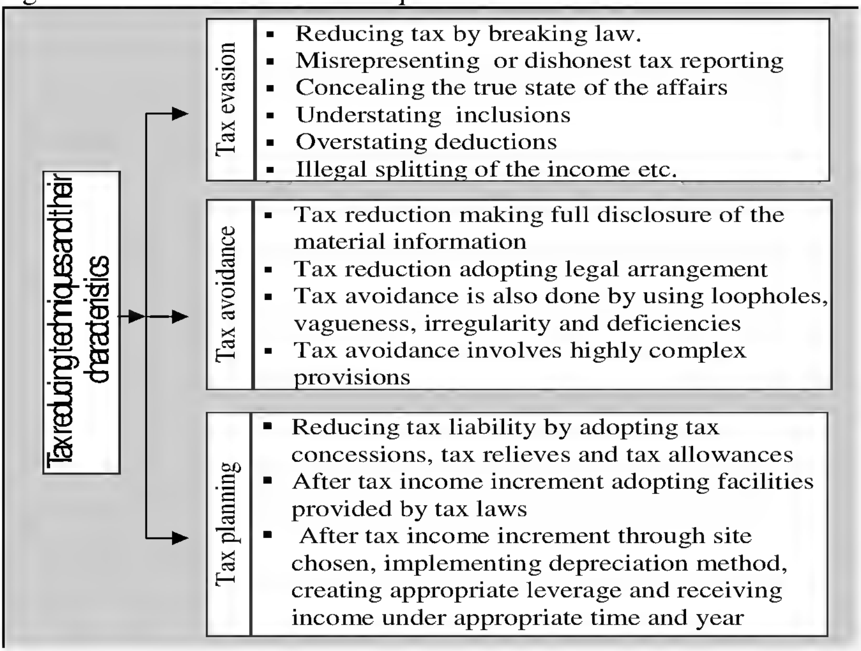
scholars have also devalued the meaning of income tax as: "Tax is root of all evil" and "Taxation is robbery" (Chodorov, 1962 p. 216). "Taxation is coerced levy that the government extracts from the populace" (Rothbard, 2004 p. 1149). The above mentioned arguments prove that any one wants to reduce his/her portion of tax to be paid. In a short sentence, if any person reduces tax through its management; it is legal and if it increase after tax earning is known as tax planning.

21.2 TAX REDUCTION TECHNIQUES

Simply tax is due that is levied on individuals or businesses to pay for running government. It may be paid in cash or kind or as labor. It is not a simple transfer of wealth from producers or consumers to government. It is levied and collected from persons by the state by means of law with force, which consists of foremost feature of compulsory nature and allows no option.

There are three techniques of tax reductions: tax evasion, tax avoidance and tax planning. These all are techniques to manipulate the sources of income or expenses or value or rate of tax. However, these are conceptually different from the legal, ethical and practical point of view. In summary, the differences of these techniques have presented in the Figure 21.1.

Figure 21.1: Tax reduction techniques



21.2.1 Tax Evasion

Tax evasion concerns illegal avoidance of taxes. It is an illegal activity in which a taxpayer seeks to hide taxable income or claim unauthorized tax deductions. In tax evasion, taxpayer escapes or reduces tax liabilities in deceit way. Consequently, it is taken as a crime in almost all countries and subjects the guilty party to fines or imprisonment. In tax evasion, most of the taxpayers misinform or not inform to the tax authority. Lord Templeman (1986) declares:

> Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment.

The stated expression confirms four elements about tax evasion: evasion concerns to not completion of information; absence of guilty tends to re-calculation and not honest is compulsory for re-assessment. The elements which can attract the criminal label to evasion were elaborated. Dickson (1986) holds that:

> An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.

Not all evasion is fraudulent. It becomes fraudulent if it involves a intentional attempt to cheat the revenue. On the other hand, evasion may exist, but may not be fraudulent, if it is the result of a genuine mistake. As with other offences, this intent may be inferred from the circumstances of the particular case. Thus, Baltic Banking Group (1998) cites:

> Tax evasion is an action by which the taxpayer tries to escape legal obligations by fraudulent means. This might involve simply failing to report income or trying to create excess deductions. This category can also be classified into two subcategories: 'Evasion of tax on income that is legally earned'; and, 'Evasion of tax on income that arises from an illegal activity such as trafficking of narcotics' Tax fraud would be the formation of sales companies that appear to deal only with unrelated parties, but in fact deal with related parties, hiding the fact that one owns a particular tax haven corporation. These tax haven corporations are also used to hide corporate receipts or slush funds.

In conclusion, tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayer's deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting 惘 declaring less income, profits or gains than actually earned; or overstating deductions. In a sentence, an illegal strategy to decrease tax burden by underreporting income, overstating deductions, or using illegal tax shelters is tax evasion.

☐ Characteristics of Tax Evasion

The tax evasion entails the following characteristics.

1. Reducing Tax by Breaking Law: Laws are basically rules that are agreed upon by a community, such as a State or a Country. Tax law is a kind of rule. Thus, if tax is made smaller in size, number, degree or intensity ignoring the provision of tax law is called reducing tax by breaking law.

EXAMPLE 21-1 A person having a source in Nepal earns a turnover of sales income Rs. 10 million. The person always uses cash payment more than Rs. 50,000 frequently ignoring provision of the Act however makes assessment deducting all expenses including cash payment more than Rs. 50,000; is reducing tax by breaking law.

2. Misrepresenting or Dishonest Tax Reporting: The misrepresentation includes both false and fraudulent report and reporting. Especially report must be represented based on fact and figure and in honest manner. Thus, any tax report if presented with dishonesty and misrepresenting of facts, is understood as tax evasion.

EXAMPLE 21-2 A person received income from investment. However, for assessment purposes, the person declares to it as business income; is misrepresentation reporting.

3. Concealing the True State of the Affairs: Concealing is hiding something, hiding fact, or putting out of sight from being found. Therefore, concealing is understood as hiding some true state of the affairs to reduce tax liability.

EXAMPLE 21-3 A person has two sources of income. For tax purposes, if the person submits one; it denotes concealing the true state of the affairs.

4. Understating Inclusions: Understating inclusions comprises few inclusions for tax purposes from actual inclusions that proportionately deduct the tax liability. It is also considered offence for tax purposes.

Example 21-4 A person earned income Rs. 40 million from three incomes: service fee, amount derived from disposal of trading stock and net gain from disposal of business assets. But, for the tax purposes the person declared only Rs. 25 million from two incomes: service and amount derived from disposal of trading stock. It is called understating of inclusions.

EXAMPLE 21-5 A person earned income Rs. 40 million from amount derived from disposal of trading stock. But, for the tax purposes the person declared Rs. 25 million. It is also called under declaring of inclusions.

5. Overstating Deductions: Overstating deduction represents gain in value or increase in value of deduction. The gain in value for deduction of cost decreases taxable income of the person and tax liability simultaneously.

EXAMPLE 21-6 A person incurred Rs. 14 million for receiving a sum of income. However, the person stated Rs. 15 million deductions for tax purposes. In this case, Rs. one million is an amount of overstated for deductions.

6. Illegal Splitting of Income etc.

Illegal splitting of income signifies dividing one or more income into two or several parts ignoring prescribed norms of law. It also helps to reduce tax liability proportionately or more. Thus, it pursues norms of tax evasion.

EXAMPLE 21-7 A person earns income from two heads: business and investment. However, for the tax purposes, if the person splits one income for his spouse making individual election, that is an illegal splitting of income.

Tax evasion is reduction of tax by illegal means. Tax evasion is made by violating Act and Rules of taxation and such actions are characterized as offences. The Offences are dealt with in income tax Act as criminal offences of taxpayers as well as tax administrators. They lead to punishment in the form of fines and imprisonment on conviction.

A person can accomplish tax evasion taking on various methods. The method of evasion may be unilateral to multilateral. Moreover, the evasions are crud violation to matching and arm length principles in field of taxation.

☐ Illegal Income and Tax Evasion

In most of the countries, illegal income is taxed as legal income. In simple, the illegal income refers to gambling, theft, drug trafficking etc. and it requires reporting unlawful profits or gains from business or investment income when filing annual tax returns, but in Nepal any persons often do not do so, because doing so could serve as an admission of guilt. The Government of Nepal has not charged to suspected lawbreakers with tax evasion when there exists sufficient evidence of tax evasion. In Nepal, most of the political parties and tax officials protect to tax evaders.

☐ Anti-Evasion Measures

Anti-evasion is a fight to overcome the evasion. Specially, anti-evasion measures take the form of statutory provisions and administrative action. The tax law may provide for withholding of tax—on dividends, interest, royalties, salary payments—estimation of taxable income in the absence of a (correct) declaration; obligation to supply information; reversal of the burden of proof; imposition of stiff penalties, etc. Administrative action includes critical examination of information received; spot checks by trained "fraud squads", etc.

Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance of New Zealand (1998) recommends to maintain a strategy of a sustained, always improving attack on tax evasion, there is a need to ensure that the IRD keeps up to date with recent literature on anti-evasion measures. Tax authority should also target types of tax evasion that involve many taxpayers evading tax on small amounts of income. Thus, to reduce or eliminate tax evasion, tax authority should be careful as: continually identify opportunities for tax evasion; continually look for new opportunities for the efficient operation of withholding tax methodologies, whether of existing or new design; develop a strong community awareness of the cost to the community of tax evasion in terms of facilities, benefits and opportunities foregone, and the increased cost of existing services and facilities; review the law relating to non-cash transactions, and effectively communicate the law to those sectors of the community where non-cash transactions are prevalent. Specially, the above explained mention points contain three basic things.

1. **Identifying opportunities for tax evasion:** By focusing on situations that provide opportunities for tax evasion, the IRD can more effectively target its audit activities. The department needs formally to evaluate the range of opportunities that taxpayers have for non-compliance with the tax system, and the circumstances in which the reporting of income may be avoided.

2. **Withholding tax systems:** The IRD should continue to look for new areas to apply withholding tax systems, taking into account their effectiveness in reducing the scope for tax evasion. This approach implies not only applying existing withholding tax systems to other areas, but also developing new systems.

3. **Community awareness programs:** The IRD or the government should develop an integrated program to alter community perceptions of the acceptability of tax evasion, and to promote voluntary compliance.

4. **Review of the law relating to non-cash transactions:** The law in relation to bartered goods and services if is unclear, that should review and case should be clear.

21.2.2 Tax Avoidance

Tax avoidance is a legal exploitation of tax system for one's own advantage, to attempt to reduce the amount of tax that is payable by means that are within the law at the same time making a full disclosure of the material information to tax authorities. In other words, for tax purposes, avoidance is a term used to describe the legal arrangement of a taxpayer's affairs so as to reduce his tax liability. It often has pejorative or uncomplimentary overtones, where for example, it is used to describe avoidance achieved by artificial arrangements of personal or business affairs to take advantage of loopholes, ambiguities, anomalies or other deficiencies of tax law. Legislation designed to counter avoidance has become more commonplace and often involves highly complex provisions. Some examples of tax avoidance schemes include locating assets in offshore jurisdictions, delaying repatriation of profits earned in low-tax foreign jurisdictions, ensuring that gains are capital rather than income so the gains are not subject to tax (or are subject at a lower rate), spreading of income to other taxpayers with lower marginal tax rates and taking advantages of tax incentives.

☐ Characteristics of Tax Avoidance

The tax avoidance entails the following characteristics:

1. Tax Reduction Making Full Disclosure of Material Information: A full disclosure is understood as the copies of all documents to make trial itself is kept for the process of fulfilling the position of legal requirement. It is done so as to show no surprises. Similarly, material information denotes information such as facts, notes, and research, used in making a work and that is sufficiently important to have a financial impact on a business organization's short or long-term performance or that would be important to a prudent investor in making an investment decision. Thus, in tax avoidance, tax is avoided from the help of a full disclosure of material information.

EXAMPLE 21-8 A person made an assessment stating full disclosure of material information to ensure tax authority as real but presented figure played dual role, if he reduced tax making an ambiguous result; is called tax reduction making full disclosure of material information.

2. Tax Reduction Adopting Legal Arrangement: Taxpayer sometime uses the method of legal arrangement to avoid tax levy. Suppose that spouses who are not actually married if made any marriage contract may be called as a legal arrangement. Spouses, they stayed jointly, but if they show the legal position as separated or divorced, are also called legal arrangement. In this case, first legal arrangement extends relief from taxable income Rs. 100,000 to Rs. 125,000 and second to increase the limitation of fixed assets such as land limit 10 Bighas to 20 Bighas.

3. Tax Avoidance is also done by Using Loopholes, Vagueness, Irregularity and Deficiencies: Tax avoider can keep away some amount by using the loopholes, vagueness, irregularity and deficiencies of the taxation law. These characters can be explained as under.

- **Loopholes**: Loopholes comprise a gap in law or a small mistake or omission in a rule or law that allows it to be under restriction. A loophole of a law, if it is used breaking its concept, may also be offensive.

EXAMPLE 21-9 A resident person operates rafting company in Nepal. He sold half of his share to a foreigner (a non-resident

person). In this case, the critical point is that Foreign Investment and Technology Transfer Act 2049 restricts the foreign investment in tourism industries to non-resident however, ITA 2002 provides facility to non-resident to operate Shipping, Air Transport or Telecommunication Service in Nepal. Moreover, the Act overrides other acts but it is not clear in relation of tax or non-tax Acts. Thus, in case of Nepal it may be loopholes due to the gap in law.

- **Vagueness:** Vagueness is unclearness by poorly expressed or not logical in meaning. Ambiguity (doubt about meaning) is one way in which the meanings of words and phrases can be unclear. Some provisions of the Act are also unclear which create confusion to taxpayers.

EXAMPLE 21-10 Foreign controlled entity must deduct dividend tax according to §69(1) but it is not necessary to deduct dividend tax according to §69(2). Therefore, tax avoider can use beneficial one between these two, is an example of vagueness.

- **Irregularity:** Irregularity is an irregular asymmetry in shape, language and meaning. Irregular language brings irregular in its administration. In a proverb, Wriston (as cited in Hansen, 2004) argues that, "All the Congress, all the accountants and tax lawyers, all the judges, and a convention of wizards all cannot tell for sure what the income tax law says." Considering complexity part of the income tax law, ITA 2002 also is not an exception of irregularities. It contains some irregularity of language in some sections.

EXAMPLE 21-11 ITA 2002 uses both words 惘 recipient and receiver – frequently. But, these do not represent different meaning always. The §69(7) and 108 are examples of irregularity in language and meaning.

EXAMPLE 21-12 The term adjusted taxable income is used in four cases: 'donation, PC cost, R&D cost and interest paid to tax exempt controlled entity' to determine value of deductions. However, the meaning of adjusted taxable income for donation purpose is quite different from other three places if there exists investment and employment income. It is another irregularity in meaning of the adjusted taxable income.

- **Deficiencies**: The term deficiencies refer a lack or shortage on provision. ITA 2002 is also not its exception. It also holds such deficiencies in provision on different sources of income.

EXAMPLE 21-13 ITA 2002 is characterized by its heads based on factors of production — land, labor and capital and returns – rent, wages and interest respectively. If a person found money on street whether it is taxable or not and which heads belongs to this money, one can hide it giving reason of lack of provision. At present, according to the Finance Act, it is final withholding. The final withholding contains windfall gains—prize, lottery, game, crossword puzzle etc.—with the lack of proper classification of income heads. However, the law can not justify principles of equity on taxation.

4. Tax Avoidance Involves Highly Complex Provisions: In tax avoidance, avoider can use highly complicated provisions that are difficult to analyze, understand, and to solve in the given circumstances.

Healey Denis concludes that, "The difference between tax avoidance and tax evasion is the thickness of a prison wall."

21.2.3 Tax Planning

Tax planning is the art and science of an arrangement of a person's business and/or private affairs in order to minimize tax liability. Specially, it deals and minimizes tax liability with the help of various concessions, allowances and relief's provided for in tax laws. In addition, it is a process of looking at various tax options in order to determine when, whether, and how to conduct business and personal transactions so that taxes are eliminated or reduced. As an individual taxpayer, and as a business owner, you will often have the option of completing a taxable transaction by more than one method. Thus, tax planning is a discipline and an attitude towards solving the problems in a methodological way from a long-term point of view. Learned Hand, Former U.S. Appeals Court Justice (as cited in Tax Alternatives, n.d.) recommends:

> Anyone may so arrange his affairs that his taxes shall be as low as possible. He is not bound to choose that pattern which best pays the Treasury. Everyone does it, rich and poor alike, and all do right; for nobody owes any public duty to pay more than the law demands.

Rangnath Mishra, Supreme Court Justice of India holds that:

> Tax planning may be legitimate provided it is within the framework of law. Colorable devices cannot be part of tax planning and it is

> wrong to encourage or entertain the belief that is honorable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay tax honestly without resorting to subterfuges.

The now classic words of Judge Learned Hand in Commissioner vs. Newman reflect the true values the taxpayer should have:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

Thus, tax planning is not only planning of the affairs of the taxpayer but also involves strategic planning, project planning and operational planning of the business enterprises.

21.3 OBJECTIVES OF TAX PLANNING

Tax research and tax planning are inseparable. Both are interrelated terms of taxation. Tax planning includes the following objectives:

21.3.1 Primary Objectives

The primary purpose of effective tax planning is to reduce the taxpayer's total tax liabilities. This statement does not mean that the course of action selected must produce the lowest possible tax under circumstances. The minimization of tax liability must be considered in context with the legitimate business goals of the taxpayer.

21.3.2 Secondary Objectives

A secondary objective of effective tax planning is to reduce or defer the tax in the current tax year. Specifically, this objective aims to accomplish one or more of the following:

☐ **Eradicating Tax Entirely**

The foremost secondary objective of tax planning is eradicating the tax entirely. To eradicate tax from investment and business is possible from strategic tax planning.

☐ Eliminating Tax in the Current Year

Minimization of tax for the year is complex phenomenon. Thus, a person's objectives are to minimize tax for the year by adopting operational planning. It is second objective of the tax planning.

☐ Deferring the Receipt of Income

Deferring the receipt of income is another crucial point of tax planning. Thus, a person has to meet objectives of tax planning from deferring the receipt if possible and beneficial to receive in the future.

☐ Converting Ordinary Income into Capital Gains

Capital gains tax rate is 10 percent forever. Unrelieved loss from business including previous year and loss from investment income during the year can be reduced from capital gain amount. Thus, from both points of view capital gain is more beneficial than profit. Thus, to convert ordinary income into capital gain is another objective of tax planning.

☐ Converting Active to Passive Income

Incomes which are received without active involvement are the passive income: income generation from a partnership without active involvement may be more beneficial than other income.

☐ Converting Passive to Active Expense

Losses from passive income are not allowable for future deduction but loss from active income such as operating a business is deductible in the future years. Thus, the objectives of tax planning are to convert passive to active expenses.

☐ Proliferating Taxpayers

The objectives of tax planning are proliferating taxpayers. The taxpayers may be formed through partnership, and proprietorship or making lifetime gifts to family members.

☐ Avoiding Double Taxation

The objectives of tax planning always have to seek to avoid double taxation.

☐ Avoiding Ordinary Income

The objectives of tax planning are to avoid ordinary income or creating, increasing, or accelerating deductions. However, this second objective should be approached with considerable reservation and moderation. For example, a tax election in one year may reduce taxes currently but burden future years with a disadvantageous tax position

21.4 AREAS OF TAX PLANNING

Planning is the process of anticipating future occurrences and problems, exploring their probable impact, and detailing policies, goals, objectives, and strategies to solve the problems. This includes preparing documents, considering alternatives, and issuing final plans. To obtain better results it is equally important in all areas. In the area of tax planning it is of vital importance. Generally, there are three broad areas of tax planning: (1) Strategic tax planning, (2) Operational tax planning, and (3) Project planning.

21.4.1 Strategic Planning

Strategic planning is a long-term planning based on the organization's overall business objectives. Strategic planning involves more than five-year duration. Using Scenarios or other planning methods strategic planning identifies Assumptions, Risks, and Environmental factors. Corporate strategic planning is a portfolio oriented planning. It is concerned with allocating resources among various businesses so that the overall value of the portfolio improves. Strategic planning at the corporate level also concerns itself with acquisitions, divestitures, internally developed new business ventures, or changing the mix of capital allocated to the company's existing businesses. Thus, tax planning may be well built from the strategic planning.

However, some writers differentiate strategic planning from long-term planning. Alliance for Nonprofit Management (2006) asserts major differences between strategic planning and long range planning. Long-term planning is generally considered to mean the development of a plan of action to accomplish a goal or set of goals over a period of several years. The major assumption in long range planning is that current knowledge about future conditions is sufficiently reliable to enable the development of these plans.

Thus, in Nepal strategic tax planning may be applied in the following conditions.

☐ **Forms of Business Organization**

Forms of business organization denote basic structure of business. Moreover, forms also include nature, structure, or essence of the business. Thus, according to the forms of business organization the possibilities are: (1) Sole proprietorship, (2) Partnership, (3) Private Limited, (4) Limited, (5) Corporations and (6) Co-operatives.

1. **Salary and perquisite from the organization:** Sole proprietor business organization is not separated from its proprietor. Thus,

any benefit or perquisite taken from proprietorship business by proprietor or family members is taken into as non-deductible amounts. The proprietor can draw his salary from his business organization but he cannot get any reduction from taxable income as reduction for family status in the case of salary taken.

In partnership firm partners cannot draw salary from their partnership business organization but in private limited business organization a managing director or any one shareholder who holds office as a staff (it is compulsory to do full time duty) of a business organization can draw salary. However, other family members or relatives of the shareholders of that private limited neither can work nor can get the salary from the private limited business organization.

But, in limited company, corporation or co-operatives business organization investors or family members can draw salary for their employment. It may be for all family members too.

2. **Reduction from taxable income**: Amount reduction from taxable income is only available to sole proprietorship business organization. Amount of reduction from taxable income depends upon family status of the sole proprietor. Moreover, family status may be elected single or couple for the income year. But, other business organizations: partnership, private limited company, limited company, corporation or co-operatives are not entitled to get such benefit from taxable income.

□ Size of Business Organization:

Tax liabilities of business organization significantly defers from its size of business turnover and investment. ITA 2002 has offered system of presumptive tax in small-scale self-employment business. However, in sole proprietorship business, the taxpayers except presumptive taxpayers fall under either ordinary taxpayers or large taxpayers.

1. Presumptive taxpayers: According to ITA 2002, threshold of turnovers and profits are taken into consideration. A self-employed having sales turnover not more than Rs. 1,500,000 and profit not more than Rs. 150,000 is taken for presumptive taxation. The basic criteria for presumptive taxation are:

1. If a resident individual's income for an income year consists exclusively of income from a business having sources in Nepal.

2. If a resident individual is not paid medical tax credit by the individual him/herself or through others during the year in respect of the individual.
3. If a resident individual has not claimed tax credit as per §93.
4. If an individual selects this provision it applies for the income year.

Moreover, the presumptive taxes vary from business zones. These zones and the fixed presumptive taxes are given as under:

1. Within an area of metropolitan and sub-metropolitan city Rs. 2,000
2. Within an area of municipality Rs. 1,500
3. Any other areas other than metropolitan and municipality Rs. 1,000

Similarly, the owners of the vehicles on hire are kept under the presumptive taxation at the rates given below. If a person is a natural person, the tax so paid is treated final and binding.

1. Minibus, mini-truck, truck and busRs. 1,500
2. Car, jeep, van, and microbus Rs. 1,200
3. Three-wheeler, auto-rickshaw, and tempo Rs. 850
4. Tractor and power tiller Rs. 750

2. Presumptive taxpayers and others: Taxpayers, who run sole proprietorship business except presumptive taxpayers can be divided into two categories on the basis of book-keeping: optional and compulsory for books of accounts keeping.

(a) **Optional for accounting record keeping:** The taxpayers having sales turnover less than Rs. 10 million get option for accounting record keeping. They can submit their income statement on the basis of books of accounts or without books of accounts.

(b) **Compulsory for accounting record keeping:** The taxpayers having sales turnover more than Rs. 10 million are compulsory for accounting record keeping. They have no option for self assessment without proper books of accounts.

Partnership firms also have both options: optional and compulsory for books of accounts as stated the sizes of business organizations while other type of business organizations: private limited company, limited company, corporation and co-operative society are compulsory for books of accounts keeping. Thus, proper books of accounts keeping boosts business expenses as compare to not books of accounts keeping.

However, in the case of event of conflict between taxpayer and tax authorities it brings more complication to not book-keeping persons.

☐ Nature of Business

Nature of business plays vital role in tax planning. There are many types of business: cottage industries, agro-based business, co-operatives, community based, and build operate and transfer (BOT) business.

1. **Domestic industry:** Income derived from domestic industry is exempted from payment of income tax. The domestic industry signifies production intensive industry of labor, traditional, skill relating to art and culture and raw material mobilization of the local level excluding dyeing, carpet, pashmina and wool cloth production used by more than five-kilowatt motor power. However, this provision of exemption applies only to them which have been already taken tax exempt certificate before Srawan 1, 2063[1].

2. **Agriculture business:** For income tax purposes, income derived by a landlord, holding the land within the ceiling prescribed in Land Relating Act, 2021 from an agriculture business is exempt from income tax. However, income from an agriculture business received by a registered firm, or partnership or company or a corporate body, or through the land above the holding ceiling as prescribed in the Land Relating Act, 2021 is taxable income.

3. **Agriculture business (land owned by trust:** For income tax purposes, income derived by a trust from an agriculture business from land owned by trust is exempt from payment of income tax.

4. **Co-operatives business:** Income derived by cooperative societies, registered under Cooperative Act, 1991 (2048) from business mainly based on agriculture and forest products such as sericulture and silk production, horticulture and fruit processing, animal husbandry, diary industries, poultry farming, fishery, tea gardening and processing, coffee farming and processing, horticulture and herb processing, vegetable seeds farming, bee-keeping, honey production, rubber farming, floriculture and forestry related business such as lease-hold forestry, agro-forestry, cold storage established for the storage of vegetables and business of agricultural seeds, insecticide, fertilizer and agricultural tools (other than machine operated) as well as income derived by rural

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[1] Income tax exemption has been avoided to domestic industries since Srawan 1, 2063.

community based saving and credit cooperatives are also exempt from tax.

5. Community based saving and credit co-operative business: Income of a community based saving and credit co-operative operated in rural areas is exempted from payment of tax.

6. Special industries: Entities wholly engaged in operating special industries thought-out the year and entities operating any road, bridge, tunnel, ropeway or flying bridge constructed by the entity or operating any trolley bus, or tram or derived income from export in an income year or the taxable income of an entity wholly engaged in the projects conducted by an entity so as to build public infrastructure, own, operate and transfer it to the Government of Nepal and in power generation, transmission, or distribution in an income-year are taxed at the rate of 20 percent. Similarly, special industries which are operated under sole proprietorship business organization are also taxed at the rate of 20 percent for the marginal bracket.

Thus, the entities and individual are taxed at the following rates:

Persons	Taxable base	Tax rate
Entity	Taxable base	20 percent
Natural person	Taxable base [Taxable income – relief]	First Rs. 75,000 @ 15 percent In balance Rs….@ 20 percent

1. Financial institution: Entities having sources in Nepal and that have business related to banking, or financial institution or general insurance business are taxed at the rate of 30 percent.

2. Petroleum business: Entities which deal with petroleum business as per Nepal Petroleum Act 2040 in an income year are taxed at the rate of 30 percent.

☐ Location of Business

ITA 2002 varies tax rate according to location of development. Thus, there are possibilities of tax planning as to business location. The tax rates differ according to its location of the country.

1. **Economically and back development region:** ITA 2002 classifies economically back development region into three categories: least developed, undeveloped and underdeveloped region. These are taxed at following rates in an income year.

(a) **Least developed area**: Special industries operated by entities or an individual in least developed areas are taxed at the following rates:

Persons	Taxable income	If special industry operated in least developed area
Entity	Taxable income	14 percent [70% of the rate 20%]
Natural person	Taxable base [Taxable income – relief]	First Rs. 75,000 @10.5% [70% of the rate 15%] In balance Rs. @ 14% [70% of the rate 20%]

(b) **Undeveloped areas**: Special industries operated by entities or an individual in undeveloped areas are taxed at the following rates:

Persons	Taxable income	If special industry operated in undeveloped area
Entity	Taxable income	15 percent [75% of the rate 20%]
Natural person	Tax base [Taxable income – relief]	First Rs. 75,000 @11.25% [75% of the rate 15%] In balance Rs. @ 15% [75% of the rate 20%]

(c) **Underdeveloped areas**: Special industries operated by entities or an individual in underdeveloped areas are taxed at the following rates:

Persons	Taxable income	If special industry operated in underdeveloped area
Entity	Taxable income	16 percent [80% of the rate 20%]
Natural person	Taxable base [Taxable income – relief]	First Rs. 75,000 @12% [80% of the rate 15%] In balance Rs. @ 16% [80% of the rate 20%]

Similarly, the Act provides another facility for natural person who are residing in remote area and gets remote area allowances. These are classified into 5 groups according to their remoteness and amount varies from Rs. 6,000 to Rs. 30,000 as prescribed by the Government of Nepal as presented below:

Table 21.1: Classification of remoteness and limit of allowance

Classification	Limit of reduction in Rs.	Classification	Limit of reduction in Rs.
A	30,000	D	12,000
B	24,000	E	6,000
C	18,000		

2. Industries established in remote area[2]: Income derived by industries established in remote area is exempted for the period of 10 income years commencing from and including the year in which the operation commenced.

3. Industries established in special economic zone: Income derived by industries established in special economic zone is exempted for the period of 5 income years commencing from and including the year which the operation commenced and after the completion of the exempted 5 income years they are taxed at the rate of 50 percent of the rate otherwise applicable to the income of that year.

4. Information technology intensive industry established in Information Technology Park (ITP): An industry if based on information technology industry and has established within ITP prescribed by the Government of Nepal, the tax is levied at the rate of 75 percent of the rate otherwise applicable to the income of that year.

5. A Special industry operated by natural person: A natural person if involved in operating special industry throughout the year or an entity involved in special industry or exports the goods or involved in infrastructure works is taxed at the rate of 20 percent of the rate otherwise applicable to the income of that year.

☐ Special Industries if Provide Prescribed Employment to the Nepalese Citizens

If a special industry of a person provides direct employment to six hundred or more Nepali citizen throughout the year, the tax is levied on 90 percent of the rate otherwise applicable to the income of that year.

☐ Merger or Amalgamation of Business

Merger or amalgamation of two or more business plays a vital role in tax planning. In an amalgamation two or more business organization carrying on business of a similar nature combines together and forms a new business. There are a number of advantages if two or more business doing similar or complimentary business join together. The main advantages are: (1) avoidance of competition and maintenance of price; (2) ready marketability of products or availability of raw materials at reasonable prices; (i.e., if a steel business company acquires a coal business company, there will be no problem of selling coal and no

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[2] Inserted by the Finance Act 2063 dated Srawan 1, 2063.

problem regarding availability of coal) and (3) reduction in costs of production and selling costs through economy of large-scale operation.

Thus, when a new company is set up to acquire the businesses of existing business organization it is called amalgamation. When one of the existing companies acquires the businesses of other companies it is a case of absorption. There is also another term reconstruction. Reconstruction indicates that an existing company on account of past losses in trading and also due to financial difficulties goes into liquidation with a view to form another company to take over the existing concern.

Thus, in tax planning merger or amalgamation is important because of two reasons: (1) profit making business organization can reduce its tax liability by amalgamating with loss making business organization forming it a new business organization, and (2) profit making (no loss making) two kinds of business can take benefit by merging business if one has low tax rate.

EXAMPLE 21-14 Business 'A' is profit making business since last 10 years and business 'B' is loss incurring business from last 5 years. If they merged making a 'C' business is called merger.

EXAMPLE 21-15 Refer back to EXAMPLE 21-14, in this context, if loss of business 'B' carry forward to business 'C' then tax liability may be significantly reduced to business 'C'.

Thus, merging a business to form new business organization can be a part of tax planning.

EXAMPLE 21-16 There are two types of businesses: one is trading and another is manufacturing (special industry). Tax rate for the trading business is 25 percent and manufacturing business is 20 percent. If they merged for a new business to form manufacturing and trading business the tax rate is only 20 percent.

☐ Capital Structure

Capital structure of a business refers to the way in which it is financed. In most of the cases, the capital structure comprises a combination of long-term capital (e.g. ordinary shares, reserves, preference shares, debentures, long-term bank loans etc.) and short-term liabilities (such as a bank overdraft and trade creditors). It is important that a business is financed by an appropriate capital structure that reflects the nature of the business and its ability to generate profits and cash flow. If a business makes its appropriate combination of debt and equity it grows return on equity on

the investors then it simultaneously reduces tax liability. Thus, capital structure is a tool of tax planning in business organization.

21.4.2 Operational Planning

Operational planning is also called a tactical planning. Operational planning deals with short-term activities, generally on a one-year timeframe. In operational planning activities are operated during the year. Moreover, operational planning are the detailed action plans to accomplish the strategic goals laid out in the strategic plan. An organization should have operating planning for each major organizational unit and correspond to its fiscal year. Thus, operational planning is a most important factor of tax planning.

☐ Personnel Remuneration and Incentives

In an effort to reduce unemployment, the tax laws of many countries provide specific tax incentives - either in the form of a deduction or a credit - available to employers who hire additional personnel (whether or not on a permanent basis) or who arrange additional training for the labor force in order to increase their skills and professional experience. The incentives may only be available in economically depressed areas of a country with a very high rate of unemployment.

In Nepal, ITA 2002 has made many provisions of incentives in cash and kind. Using these incentives one can develop an effective tax plan to reduce not only business income but also to reduce income from employment. For the purpose of tax planning the business organization can make benefit by supplying the following facilities: vehicles facility, accommodation facility, and providing meal in business premises in similar manner instead of allowance to them.

Moreover, tax planning may be applied by selection of family status for reduction from taxable income. Similarly, reduction from taxable income comprises life insurance premium, pension income and remote area allowance if they exist for the year.

Medical tax credit can be applied to reduce tax liability if it falls under the approved medical treatment expenses.

☐ Acquiring Fixed Assets

Acquiring required fixed assets is another method of tax planning. Business organization requires different types of fixed assets: plant and machinery, vehicles, building, trust, land etc. These assets can be acquired from different methods. In tax planning the method has to be chosen in such a manner which reduces maximum tax liability and decreases cash outflows.

☐ Capitalization of Semi-Revenue Costs

Business organizations are allowed to deduct R&D costs and PC costs up to 50 percent of adjusted taxable income. If these exceed 50 percent, they are capitalized to fixed assets in pool 'D'. These capitalized amount increase depreciation allowance by 15 percent of its tax base in the following year(s). Similarly, business organizations are allowed to deduct interest paid to their parent company (tax exempt controlled entity) up to 50 percent of adjusted taxable income. If interest exceeds 50 percent of the adjusted taxable income, the exceeded amounts are allowed to deduct from the following income year(s). However, these are not capitalized. Thus, these costs may be reliable tools for tax planning.

☐ R&I Costs

The term R&I costs for tax purposes is used to denote the following: (1) costs incurred for preserving assets used in business or investment to its existing condition, and (2) costs incurred for partial additions during the year. Thus, it is limited up to 7 percent of its depreciable base for deduction during the year. Excess amount of repair and improvement costs are capitalized in corresponding heads of the assets to provide depreciation in the following year/s in business or investment. Thus, repair and improvement costs play significant role in tax planning.

☐ Inventory Valuation Methods

There are varieties of inventory valuation methods but in most countries only few methods are permitted for tax purposes. The most common inventory valuation methods for tax purposes are market value; cost price; and cost price or market value, whichever is lower. It is often impossible to determine which substitutable goods have been sold and which are still in stock, particularly when the goods are mixed. To overcome these problems the following valuation methods exist in practice: Last in first out (LIFO), first in first out (FIFO), average cost; base stock method; and replacement value. With the exception of the FIFO method which may be applied for tax purposes in a number of countries, most of these methods may not be used for tax purposes.

In Nepal, there are two accounting methods as options to those other than companies: cash accounting and accrual accounting methods. When a person is in cash accounting method either prime cost or absorption method can be adopted. But the person who is in accrual accounting method should compulsorily adopt absorption method for stock valuation. Thus, stock valuation method can be applied for tax planning.

21.4.3 Project Planning

In taxation, project planning is the process to quantify the amount of time and budget a project will cost. The purpose of project planning is creating as a project for new investment in plant and machinery for making additions, modernization, renovation or creation. For the purpose of tax planning project planning may be benefited by two reasons: (1) it incurs more costs which can be deducted in future year/s as allowances or costs, which helps to reduce tax liability and (2) it grows sales, employment and benefit to the society.

Under the project planning the activities may be planned for expansion and diversification of business, make or buy decision, disposal of fixed assets, modernization or replacement or repair of the existing assets etc. Thus, project planning can help to minimize tax and to increase the after tax benefits.

Thus, tax planning is the process of finding every possible legal ways to reduce tax burden. Most of the scholars have pointed out, endeavoring to pay very little in taxes in a legal manner is neither unethical nor immoral.

21.5 A GENERAL FRAMEWORK FOR INCOME TAX PLANNING

The primary goal of tax planning is to design a transaction so as to minimize tax liability and to increase non-taxable income. The idea of an analytic framework which classifies tax planning techniques is based on the answer to a fundamental question: why tax plan in the first place? A set of principles that fundamentally shape tax rules and an analytical framework that classifies tax planning techniques are based on income statement that can guide to minimize tax liabilities.

Figure: 21.2 Income statement and to arrive at taxable base

Calculation	Particulars	Entity	Individual
(1) Income earned		××	××
(2) Less	Excluded income	(×)	(×)
(3) Inclusions —income that is subject to tax (1-2)		××	××
(4) Deductions:	(a) General deductions	(×)	(×)
	(b) Specific deductions	(×)	(×)
(5) Business or investment income (3-4)		××	××
(6) Deductions:	(a) Loss deduction	(×)	(×)
	(b) Other deductions	(×)	(×)
(7) Taxable income (taxable base for entity) (5-6)		××	××
(8) Reductions:	(a) Individual or	-	(×)
	couple/dependency limit	-	(×)

	(b) Pension income (c) Disable facility (d) Others: (1) Life insurance (2) remote area allowance (3) foreign allowance facility		
(9) Taxable income/base for individual (7-8)		-	××
(10) Tax amount (tax base × tax rate %)		××	××
(11) Less: Medical tax credit		-	(×)
(12) Tax liabilities		××	××

The above figure reveals a series of tax minimization strategies if we analyze carefully. Through creative tax planning that also takes into consideration a client's non-tax concerns, each component of the tax formula can be managed in a way that will help to minimize the taxpayer's tax liability.

The tax planning strategies relate various sub-featured strategies which are presented as stated below:

21.5.1 Tax Minimization Strategies Related to Income

Some significant tax minimization strategies related to income can be traced as given below:

□ Avoid Income Recognition

ITA 2002 defines in §2(h), income as a person's income from any employment, business, or investment and the total of that income calculated in accordance with the Act. It means all incomes from whatever source derived. However, the Act has made provisions that allow various types of income to be excluded from the taxable base. There are a number of exclusions available for individuals, but few are available for entities.

EXAMPLE- 21-17 Average employees of 'A' Company Limited are 25 percent bracket taxpayer. In negotiations with the employees' union, the limited proposes that it will increase the amount it spends on non-taxable fringe benefits by an average Rs. 6,000 per employee in lieu of granting Rs. 6,000 average salary increase. The average employee will be better off by Rs. 1,500 if the union accepts an offer from the Limited as shown below:

Alternatives	Salary increase	Fringe benefit increase
Value of compensation received	Rs. 6,000	Rs. 6,000
Tax on employee's compensation	Rs. 1,500	–0–
After-tax increase in compensation	Rs. 4,500	Rs. 6,000

Although the average employee receives Rs. 1,500 benefit, there is no tax cost to the Limited because both fringe benefits and salaries are deductible to the Limited.

Figure: 21.3 General frameworks for income tax planning

Tax formula	Tax planning strategy	Tax planning examples
Income and exclusions	• Avoid income recognition	• Compensate employees with non-taxable fringe benefits (EXAMPLE 21-17) • Make a sale of land and a private building less than Rs. 10 million
	• Postpone recognition of income to achieve tax deferral	• Postpone sale of assets (EXAMPLE 21-18)
□ Deductions	• Maximize deductible amounts	• Transfer ownership of assets (EXAMPLE 21-19)
	• Accelerate recognition of deductions to achieve tax deferral	• Elect to deduct provisions in year of pledge rather than in year of payment (EXAMPLE-21-20 to 21-21)
Taxable income and Tax rates	• Shift net income from high- bracket years to low-bracket years	• Postpone recognition of income to a low-bracket year (EXAMPLE 21-22 to 23) • Postpone recognition of deductions to a high-bracket year (Example 21-24).
	• Shift net income from high- bracket taxpayers to low-bracket taxpayers	• Pay family member to work in the family business (EXAMPLE 21-25)
	• Shift net income from high-tax jurisdictions to low-tax jurisdictions	• Establish subsidiary operations in state or region or countries with low tax rates (EXAMPLES 21-26 and 21-27)
	• Control the character of income and deductions	• Hold assets long enough to qualify for long-term capital gain rates before selling them (EXAMPLE 21-28). • Ordinary loss may be reduced by the investment profit or capital gains; again capital loss may be reduced by the capital gain (EXAMPLE 21-29 and 21-30).
	• Avoid double taxation	• Operate as a proprietorship rather than limited company. (EXAMPLE 21-31, 32 & 33)

		• Maximize deductible expenses paid by a company to a shareholder/employee (EXAMPLE 21-34)
Income tax credit	• Maximize tax credits	• Maximize the qualifying expenses for further benefit to take tax credit (EXAMPLE-21-35 & 36)

Sale of land and a private residence of an individual that is disposed off for less than Rs. 10 million is neither non-business taxable asset nor is taxable. Thus, a person can choose to sale property less than Rs. 10 million.

☐ **Postpone Recognition of Income to Achieve Tax Deferral**

ITA requires that both income and expenses be reported in the proper year. If there were no requirements like this, taxpayers could freely shift income and expenses from year to year to take advantage of tax rate differentials or could defer tax liabilities indefinitely. Although various rules limit the shifting of income and deductions across times, some opportunities still exist.

> **EXAMPLE 21-18** A person purchased land and building in Rs. 15 million for personal use and after 2 years the person wish for sale to it for Rs. 16 million. In view of tax planning, it is beneficial to sale after one year to tax deferral and to recognize it on non-business taxable assets for capital gain tax.

21.5.2 Tax Minimization Strategies Related to Deductions

Tax liabilities may be reduced through planning of proper deductions. Some examples of planning of deduction are presented below.

☐ **Maximize Deductible Amounts**

If an individual owns vehicles it is not permitted for deduction of depreciation but if it is under the ownership of the business enterprises the depreciation is permitted. Thus, it is possible for an individual businessperson to maximize the deductible amounts by transferring any depreciable property from individual to business enterprise.

For individual or entities with an annual turnover amounting rupees two million or more, in principle, the deductions are not allowed for cash payment in excess of rupees 50,000 at one time. Where cash payment is defined as a payment made other than through a bank or financial institution by way of letter of credit, check, draft, money order, money

transfer (hundi) or any other form. To recognize the expenses it is possible by splitting of payment into more.

EXAMPLE 21-19 A proprietor of a Firm owns a vehicle in personal name and uses it for business. It is better to transfer under firm's ownership to increase expenses from fuel and depreciation. In this position, frequency of use remains same however, cost of the vehicle transfers to business.
In addition, any personal asset if used for business is beneficial to transfer in business organizations. This technique maximizes business expenses.

☐ Accelerate Recognition of Deductions to Achieve Tax Deferral
Both sole proprietorship business organization and entities other than company may elect method of accounting. Generally, deduction is allowed only for the year in which the payment is made for the cash basis accounting business enterprises. In this situation, they are encouraged to adopt accrual basis of accounting considering effect of matching principles. Those business enterprises may claim the deductions in the year preceding payment if that met the recognition of provisions.

EXAMPLE 21-20 A person, an accrual basis business organization, wishes to write-off bad debts of Rs. 10,000. In this condition, if the person writes, it may offer two benefits: minimization of tax, investment of saved money. In addition, in most of cases it may reduce tax brackets from higher to lower.

EXAMPLE 21-21 Accrual basis method of taxpayer can defer more tax than cash basis method. The accrual basis method of taxpayer can make provisions of expenses — telephone charges, water and electricity, auditor's fee etc. — that can make expense for the year but payment can make in the following year/s. These payments also assist to take advantages from tax deferral.

21.5.3 Tax Minimization Strategies Related to Tax Rates
Tax minimization strategies should consider tax rates. Considering other factors of benefit, income should be deferred to take advantages.

☐ Shift Net Income from High-Bracket Years to Low-Bracket Years
The objective of shifting income is to defer the payment of income tax for the first time (refer to EXAMPLE 21-14). A second time-shifting strategy is to move net income (which is received after withholding) from high-tax to low-tax years. This can be accomplished by shifting

income from high-bracket years to low-bracket years or by shifting deductions from low-bracket years to high-bracket years.

EXAMPLE 21-22 A person is in 25 percent bracket for the year but expects to be in the 15 percent bracket in next year. The person who is receiving some contractual amount of income and such contract is of flexible nature, it would be better for him to receive the amount in the later year.

EXAMPLE 21-23 A person has an option to retire in either of the consecutive years. If the final withholding payment rate is 10 percent for the first year and it becomes five percent in the later year, it would be beneficial to retire in later year.

In these cases, the income-shifting strategy is used to accomplish two tax-planning objectives. First, shifting the income defers the payment of income tax from first to later year. Second, the shifting strategy results in the income being taxed at a rate of smaller rather than larger.

EXAMPLE 21-24 A Business Organization has been sued by a customer for Rs. 125,000 on damage and the court settled the case between parties making the organization to pay only Rs. 100,000 in June (Ashadh). The Organization expects to be in 20 percent tax bracket for the year and 25 percent tax bracket in the later year. The Organization saves Rs. 5,000 [Rs. 100,000 × (25% - 20%)] in income tax if it pays the damages in the following income year rather than income year.

☐ Shift Net Income from High-bracket Taxpayers to Low-Bracket Taxpayers

Individual income tax rates range from 15 to 25 percent. There are several provisions in tax law to prevent shifting income from high-bracket taxpayers to low-bracket taxpayers. Business organization can be effective vehicles for shifting income to low-bracket taxpayers.

EXAMPLE 21-25 Mr. Karki and his spouse are equal shareholders of a Private Limited Company. Mr. Karki projects that it will earn Rs. 240,000 during the year and it will be taxed on this income at 25 percent marginal rate. Then he decides to employ both of them for 6 months each. The company decides Rs. 20,000 per month for each taxpayer. This reduces income tax of Mr. Karki by Rs. 15,250 (taxable base Rs. 115,000 and tax liability Rs. 21,250). Where each reports taxable income (taxable base) of Rs. 20,000 (Rs. 120,000 – Rs. 100,000 standard reduction for individual) and pays Rs. 3,000 of

income tax (Rs. 20,000 × 15% rate). As a result of this income-shifting strategy, the family unit saves Rs. 15,250 per year.

☐ Shift Net Income from High-Tax Jurisdictions to Low-Tax Jurisdictions

The state or region or country where income is earned (or where a deduction is incurred) can have a large effect on an entity's overall tax liability. Hence, shifting income from high-tax jurisdictions to low-tax jurisdictions or shifting deductions from low-tax jurisdictions to high-tax jurisdictions is an important tax planning strategy.

EXAMPLE 21-26 A Company owns a sales subsidiary in Kathmandu and a manufacturing subsidiary in Humla is imposed 14% tax rate on special industries. The Humlian subsidiary makes goods and sells them for Rs. 4 million to the Kathmandu subsidiary, which then modifies them and offers them for sale to businesses in Pokhara for Rs. 8.4 million. The cost of manufacturing and modifying each goods is Rs. 3 million. Out of Rs. 5.4 million of profit earned, Rs. 1 million is attributable to the Humlian (which is subject to a 14% tax rate), and Rs. 4.4 million is attributable to Kathmandu (which is subject to a 20% tax rate). The company's total tax liability is 1,020,000 [(Rs. 1,000,000 × 14%) + (Rs. 4,400,000 × 20%)].

EXAMPLE 21-27 Refer back to EXAMPLE 21-26 and assume that the Company expect Rs. 5 million of profit attributable to the Humlian and Rs. 400,000 attributable to the Kathmandu. In this case, the Company's total tax liability is Rs. 780,000 [(Rs. 5,000,000 × 14%) + (Rs. 400,000 × 20%)]. Thus, by altering the amount of work done in each of the two subsidiaries and the amount of income generated by each, the Company's tax liability decreases by Rs. 240,000 (Rs. 1,020,000 – Rs. 780,000).

☐ Control the Character of Income and Deductions

Due to various policy reasons, government treats certain categories of income and losses more favorably than others. For instance, the provisions that tax on capital gains at a maximum rate of 10 percent compared to a 15 or 25 percent rate on ordinary income were enacted to encourage individuals to make long-term investments of capital in the economy.

EXAMPLE 21-28 A proprietor of a Sole Trading Concern must report all of sole business transactions on behalf of individual income tax return. On July 1, in an income year, he invested Rs. 25,000 excess cash of business in stock. On July of following year,

the stock was worth Rs. 35,000. The proprietor, who is 25 percent bracket taxpayer, has decided to sell the stock and use cash to increase business inventory. In this position, the gain is treated as capital gain and he has to pay only 10 percent tax on the gain and he saves 15 percent tax of Rs. 10,000.

To encourage investment in small businesses, government has made provisions, which provide favorable treatment of losses incurred on the sale of qualifying small business stock. Generally, losses on the sale of stock regards to capital losses. Individuals with capital losses in excess of capital gains are permitted to deduct from other capital gains. Capital gain may be reduced by ordinary business loss of the current year and accumulated business loss of the previous year.

EXAMPLE 21-29 A resident natural person invested Rs. 80,000 in stock and sold the stock during the year for Rs. 40,000. In the same year he gained from stock transactions Rs. 60,000. In these condition, the capital gain may be reduced by the capital loss due to this reason. Hence, he has to pay capital gain tax only on Rs. 20,000.

EXAMPLE 21-30 A resident person operates a Factory under a sole shareholding. In an income year, the factory incurred loss Rs. 50,000. In the same income year, the person received capital gain Rs. 20,000. In this position, the business loss reduces capital gain. Remaining portion loss can forward to the following year(s). Similarly, in the following year, loss or gain again may occur.

☐ Avoid Double Taxation

A person can choose one among various business forms: Sole Proprietorship, Partnership, Partnership (Limited), Private Limited Company and Limited Company. Sole Proprietorship and Private Limited Companies are possible business form with sole shareholding.
Sole proprietor and partnership are free from double taxation. Dividend taxation is a kind of double taxation. It is levied to all types of business enterprise. The partnership firm is subject to corporate flat tax. Considering these merits and demerits, sole proprietorship firm is most beneficial from taxation point of view.

EXAMPLE 21-31 A Company earned taxable income Rs. 500,000. It retained profit for distribution Rs. 375,000 after payment of corporate tax Rs. 125,000. It declared Rs. 375,000 for distribution of dividend. However, again the Company has to deduct 5 percent dividend tax to distribute dividend. In this position, the tax ratio to company represents as given below:

Taxable income/base			Rs. 500,000
Particulars	**Dividend**	**Taxes**	**% on taxable base**
Corporate tax 25 % for ordinary business		125,000	25%
Distribution of dividend	375,000	18,750	5%
Total tax paid	375,000	143,750	28.75

Thus, in Company the shareholders have to pay more tax.

EXAMPLE 21-32 Refer back to EXAMPLE 21-31, if same taxable income is earned by a Partnership Firm the payment of tax amount and percent of tax on taxable base is as given below:

Taxable income/base			Rs. 500,000
Particulars	**Profit retained**	**Taxes**	**% on taxable base**
Taxable income			
Flat tax rate 25% for ordinary business		125,000	25%
Profit taken / used by partners	375,000		
Total tax paid	375,000	125,000	25%

Thus, in Partnership Firm partners pay less tax than a Company and more tax than a proprietor of Proprietorship firm.

EXAMPLE 21-33 Refer back to EXAMPLE 21-31, if same taxable income is earned by a proprietor from proprietorship business the payment of tax amount and percent of tax on taxable base is as given below:

Particulars	Profit	Profit retained	Taxes	% on tax base
Taxable income	500,000			
Reduction of individual limit	100,000			
Taxable income (tax base)	400,000			
First limit Rs. 75,000			11,250	15%
In balance Rs. 325,000			81,250	25%
Profit taken/used by proprietor		307,500		
Total tax paid	100,000	307,500	92,500	23.125

Thus, in sole proprietorship business a proprietor pays less tax than a Partnership Firm and a Company.

Choosing to operate as an entity or firms is not the only way to avoid double taxation. Double taxation can be avoided or minimized by making payments such as salaries, rent, and interest to the shareholders/partners.

EXAMPLE 21-34 A resident person is a partner of a Partnership firm. He can legally obtain interest income if invested more than

required amount in the firm after deducting 6% tax at source. Similarly, if the person is the sole shareholder of a company he may reduce his company's net income taking more salary and salary may also be reduced by various provisions. Again, one can open limited company including family members and net income may be reduced by distributing various salaries instead of dividend distribution.

☐ Tax Minimization Strategies Related to Tax Credits

The tax liability may be reduced by maximizing tax credits. Nepal exists three types of tax credit: Medical tax credit (for resident natural person), advance tax credit and tax credit by maximizing certain types of costs (R&I costs, PC costs, R&D costs and interest paid to exempt controlled entity).

1. **Utilizing medical treatment expenses**: Medical tax credit may be a tool of maximizing tax credit to reduce tax liabilities. The excess amount of medical tax credit can be deducted in the following year(s). Thus, it helps to maximize tax credit for the resident natural person.

   EXAMPLE 21-35 Suppose that a resident natural person spent Rs. 8,000 for approved medical treatment expenses in an income year. In this position, the person can deduct Rs. 750 medical tax credit equivalent of Rs. 5,000 medical treatment expenses during the year. Remaining portion of Rs. 3,000 can be deferred as medical tax credit in the following year.

2. **Submit income statement to get tax credit**: In ITA 2002, the most of payments are of withholding nature. Thus, to get tax credit from the amount of withholding a person has to submit income statement in timely to get benefit from that tax credit.

3. **Tax credit from maximizing costs**: Costs of special nature are deferred if they exceed the given ceiling. Thus, a person can attain benefits from costs maximization which is compulsory to be spent.

   EXAMPLE 21-36 A business enterprise may reduce its income by 7 percent for R&I cost, 50 percent for R&D and PC of its adjusted taxable income. Moreover, excess amount are transferred as capital for the future year. In the following year these proportionately appreciate depreciation allowances.

REVIEW QUESTIONS AND CASES

1. What is tax planning? How does it differ from tax evasion?
2. Discuss the need for tax planning. How far is it relevant in Nepal?
3. The government has attracted the potential investors to promote industries in remote, undeveloped and underdeveloped areas for the balanced growth of the country. Justify this statement.
4. "Income tax planning is reduction of tax expenses and increment of after tax benefits." Elucidate this statement.
5. Write a note on tax incentives and facilities available for export promotion in Nepal.
6. What tax relates to new industrial units in Nepal? Explain.
7. A successful tax planner employee's its expenditure scheme in such a way that both the employers and employees would be benefited mutually. Justify this statement in the view of a salaried person. [MBA 2056, TU.]
8. Tax planning is a scheme where by a taxpayer can manage its cash flow properly. Explain this statement in the light of timing of activities. [MBS, Model 2057, TU.]

21.6 TAX PLANNING UNDER VARIOUS PAYMENTS AND ACTIVITIES

Tax planning can apply in the various payments and activities. Individually it takes a long list. However, for the purpose of study, it is divided into six broad payments activities: employment income, self-employment, and capital structure, selection of industrial location, outright purchase or hire purchase and timing activities planning.

21.6.1 Employment Income

Fundamentally, tax-planning relating to employment activities has to be beneficial to both employer and employee. In many cases, payment of a payer may be deductible expense when it is chargeable to tax for recipient. In case of employment both persons: employer and employee must be benefited by the payment of perquisites and receiving the perquisites. If any payment does not agree with this principle, that will be less beneficial. Thus, some significant ideas of tax planning relating to employment activities are presented below:

☐ Tax Minimization from Employment Income

A tax minimization model has to contemplate at least the following two facts:

- Reduce taxable income upgrading non-taxable income

- Reduce tax liability upgrading tax benefits

Table 21-4: A model for reduction of employment income

Income and exclusions	
1. Avoid income recognition	1. Compensate employees with non-taxable fringe benefits (**EXAMPLE 21-37**) 2. Split employee's facility into a small amount (**EXAMPLE 21-38**)
2. Receive / obtain some facility in kind rather than in cash	3. Receive / provide facilities in kind rather than allowances [**EXAMPLE 21-39**]
3. Postpone recognition of income to achieve tax deferral	4. Try to receive benefit in later year (**EXAMPLE 21-40**)

1. Compensate employees with non-taxable fringe benefits: According to the Act, meals or refreshments provided in premises operated by or on behalf of an employer to the employees that are available to all employees on similar terms is excluded income for the employee and deductible expenses for the employer [§8(3)(b)]. Thus, this may be a manipulated trick by providing benefit against taxable income.

EXAMPLE 21-37 Average employees of a Limited are 25 % bracket taxpayer. In negotiations with the employee's union, the Limited proposes that it will increase the amount it spends on non-taxable fringe benefits by an average amounting Rs. 6,000 per employee in lieu of granting Rs. 6,000 average salary increase. The average employee will be better off by Rs. 1,500 if the union accepts the Limited offer, as shown below:

Alternatives	Salary increase	Fringe benefit increase
Value of compensation received	Rs.6,000	Rs.6,000
Tax on employee's compensation	1,500	0
After-tax increase in compensation	Rs. 4,500	Rs. 6,000

Although the average employee receives Rs. 1,500 benefit, there is no tax cost to the Limited because both fringe benefits and salaries are deductible costs for the Limited.

2. Spilt employee's facility into a small amount: Payments of prescribed small amounts to employees which are also unreasonable or insignificant or administratively impracticable for accounting are

exclusion from income of employee but deductible for employer. It includes a payment of an amount not exceeding Rs. 500 at a time for payment of tea, stationery, awards, emergency medical treatment, or a similar provisions approved by the IRD. The splitting principle is not equally beneficial to all types of employer but it is more beneficial to small-scale organization or employer. An organization having few numbers of employees can follow it interchangeable pattern as given below.

EXAMPLE 21-38 A business organization, having two staffs offers to increase benefit of its employees. In this case, the organization can provide facility of tea, stationery, awards, emergency medical treatment or conveyance facility instead of increment in their salary.

3. Receive/provide facilities in kind rather than allowances as an amount: Employer can also offer facility in kind. Thus, in employee's point of view these two facilities may be beneficial in kind rather than in cash.

- The use or availability for use of a motor vehicle wholly or partly for private purposes of the payee has to be quantified as where the person is an employee or worker or a person who is remunerated by the payer on a monthly basis at the rate of 0.5 percent on the remuneration of the person.
- The use of a house to a beneficiary including an employee or a worker wholly or partly for private purposes should be quantified as where the person is an employee or worker or a person who is remunerated by payer in a monthly basis at the rate of 2 percent on the remuneration of the person.

EXAMPLE 21-39 Assume that an employee incurs transportation costs Rs. 9,000 per annum and gets transportation allowance Rs. 6,000 from his employer. The employee gets salary Rs. 150,000 per annum including transportation allowance. In this context, if the employer offered vehicle facility to the employee; it reduces taxable income to Rs. 144,720 (salary Rs. 144,000 + fringe benefit from vehicle Rs. 720). In result, the employee can save Rs. 3,000 as excess amount for transportation costs and at least 15 percent income tax of Rs. 5,280.

Similarly, assume that the above person incurs Rs. 36,000 as house rent. In this circumstance, he can save Rs. 33,120 [rent expense Rs.

36,000 minus Rs. 2,880 as amount decided for accommodation if provided by the employer) from the payment of rent.

3. Receive benefit in later year: If an employee is taxable in marginal bracket for the year and there is possibility of low bracket in the following year and s/he is going to receive that payment in nearly end of the year, at this situation the amount must be postponed for the following year.

EXAMPLE 21-40 An organization policy offers to pay overtime amount at the end of each year. In this context, an employee may benefit by receiving it in the following year.

☐ Tax Minimization through Maximization of Deductions from Assessable Income

There is no any deduction from employment income. However, two deductions are available from the assessable income. Assessable income is obtained after adding the assessable income calculated from each heads.

Table 21.5: Maximize deductions from assessable income

Maximize deductible amounts	1. Take benefit from approved retirement fund. 2. Take benefit from making investment in CIT. 3. Make donation (if it is related for further benefit).

1. Don't miss to take benefit from approved retirement fund: An employee (including an individual) is allowed to reduce approved retirement fund from his assessable income. It is deductible upto 1/3 of the assessable income or Rs. 300,000. Thus, an employee of an organization may take benefit from the retirement savings even he is not granted for retirement contribution by his employee.

☐ Tax Minimization through Maximization of Relief from Taxable Income

Maintain family status	1. Always choose beneficial family status **[EXAMPLE 21-41]** 2. Try to get status of resident
Maximize reduction	3. Don't miss to take remote area facility (if granted) 4. Maximize reduction from life insurance premium as a tax credit 5. Choose a pension income if it is beneficial from NPV

1. Always choose beneficial family status (individual or couple/dependency): In case of a married resident couple, each spouse is taxed individually. However, married resident couple can elect to be treated as an individual for a particular income year.

EXAMPLE 21-41 A husband and his spouse both are working in a hospital for the income year. Being both employed they decided to be individual and notified IRD in writing, and they are treated as individual accordingly for the year. After the end of that income year, the contract of the spouse terminated and remained goodwife. Thus, they made as a couple for that income year legally. In the next income year, the spouse operated a business and they informed IRD to be an individual and they made as an individual accordingly.

In this case their income is clubbed and added together. If the income of both spouses is added up the basic exemption threshold for couple applies. If the income of both spouses is calculated separately, each spouse can claim the basic exemption threshold for individuals. If a couple elects to be taxed as couple each spouse is jointly and individually liable together with the other spouse that the tax for the couple is paid.

2. Try to get status of resident: The income tax act distinguishes between resident and non-resident persons. Income tax in an annual basis is normally imposed only on the income of residents. A non-resident with residential income is subject to income tax in final withholding basis.

An individual is residing in Nepal if:

- The normal place of abode of the individual is in Nepal.
- The individual is present in Nepal for 183 days or more in any period of 365 consecutive days.
- The citizenship of the individual is not relevant for taxation purposes. Nepal's right to impose income tax on an individual is solely linked with the residence of the individual. A special rule applies to government officials. The income of employees or officials of the Government of Nepal is fully taxable in Nepal even if they are posted abroad.

The resident taxpayer is allowed for reduction of amount as per family status however, non-resident does not get any reduction of family status.

3. Don't miss to take remote area facility if possible: The following amounts for following remote areas are increased in the basic exemption limit of the taxable income for individuals:

(a) For Class A remote areas Rs. 30,000;
(b) For Class B remote areas Rs. 24,000;

(c) For Class C remote areas Rs. 18,000;
(d) For Class D remote areas Rs. 12,000; and
(e) For Class E remote areas Rs. 6,000.

4. Maximize reduction from life insurance premium as a tax credit: A taxpayer may reduce his taxable income from payment of life insurance premium. It may reduce with 7 percent of the insured amount or Rs. 10,000. Thus, an employee (including an individual) may be benefited making investment insurance.

5. Choose a pension income if it is beneficial by net present value: A taxpayer may reduce his taxable income if he has pension income. It may reduce by 25 percent of the reduction of family status or pension income whichever is lower.

☐ Tax Minimization through Reduction of Tax Rate and Brackets

Tax planning is an effort to reduce tax liability and to increase after tax earning. Thus, in the process of tax planning before the end of the year these following techniques may be beneficial if they are possible.

1. Shift net income from high-bracket years to low-bracket years	1. Postpone recognition of income to a low bracket tax year
2. Shift net income from high-bracket taxpayers to low-bracket taxpayers	2. Create income of spouse and spilt the income for low bracket taxpayer

Postponement to recognize income to a low bracket tax year is a crucial issue. However, it may be possible through sound tax planning. Similarly, income splitting must be recognized by tax theory. Any splitting of income by violating tax law is not tax planning either it will be evasion or avoidance.

☐ Tax Minimization through Maximizing Tax Credit to Reduce Payment of Tax

Tax liability may be reduced by tax credit only. Thus, there are two items to reduce it. For this, possibilities are: medical tax credit and withholding tax.

Maximize tax credits	1. Maximize the qualifying expenses for medical to take tax credit 2. Always submit tax credit (if withholding is aside any where)

1. Medical tax credit: A resident individual can claim a medical tax credit for an income-year for any approved medical costs paid by the individual or through others during the year in respect of the

individual. But, such medical tax credits are prescribed up to certain limit. Thus, a resident individual can claim medical facility whichever is lower up to 15 percent of approved medical treatment expenses or Rs. 750. If amount of medical treatment expenses exceeds the prescribed limit, the excess amount is deducted from income of the following year or years.

EXAMPLE 21-42 An employee of an organization fell sick and his employer treated him incurring Rs. 15,000. Thus, this amount is treated as income of the employee and Rs. 750 is made for tax credit during the year and Rs. 10,000 is transferred to the following years for same purposes.

2. Exclusions from medical tax credit: Costs incurred for cosmetic surgery are not treated as approved medical costs. Also, if costs incurred in filing prescriptions of diagnosis, or payments for filing prescription bills counting the purchase of medicine as described above are reimbursed by an insurance company under a health insurance plan, they cannot be claimed as a medical tax credit because the taxpayer does not directly pay them.

EXAMPLE 21-43 A person earning taxable income had done cosmetic medical surgery of his fore arm during an income year and incurred Rs. 15,000. But, this amount is not treated for medical tax credit because the amount of cosmetic surgery does not fall under the medical tax credit. In addition, to get medical tax credit by an individual, the paid amount must appreciate his income in any way.

Tax planning is a crucial subject. It varies from scholar to scholar. It requires great in depth knowledge. Certainly it is difficult than assessment of employment income. However, it has no adequate areas to reduce tax liability and to increase the after-tax earning as compared to other income heads.

CASES AND SOLUTIONS

1. An individual has been working in a Company as a permanent employee since last 10 years. He has been receiving Rs. 25,000 salary per month and other facilities. The other facilities are provided on the basis of actual cost of the employee. However, both are seeking to reduce tax liabilities. As tax planner advise best alternative to reduce tax liabilities for the individual.

Actual costs of the employee and facility provided by the employer are:
1. Transportation cost allowance Rs. 750 per month
2. House rent allowance Rs. 4,000 per month
3. Tiffin allowance Rs. 2,500 per month
4. Retirement contribution 10% of the salary.

Solution:

Calculation of tax liabilities before tax planning of an individual for the income year 2063/064

INCLUSIONS		**Amount**	
1	Salary	300,000	
2	Transportation allowance	9,000	
3	House rent allowance	48,000	
4	Tiffin allowances	30,000	
5	Retirement contribution - by employer	30,000	
Assessable income from employment		417,000	417,000
Assessable income			417,000
DEDUCTIONS FROM ASSESSABLE INCOME			
	Contribution to retirement fund [by both]		60,000
Taxable income			357,000
REDUCTION FROM TAXABLE INCOME [for individual]			
Reduction: Individual limit			100,000
Taxable income/base			**257,000**
CALCULATION OF TAX LIABILITIES			
	First limit Rs. 75,000 @ 15%		11,250
	In balance Rs. 182,000 @ 25%		45,500
CALCULATION OF ADDITIONAL TAX			
	1.5% of the taxable base Rs. 182,000		2,730
Tax liability			59,480

Clarification:

- ☐ **Possibilities of Tax Planning if Employer Provides Substitute Facilities**
  - (a) Transportation allowance may be reduced providing motor vehicles. If a person is an employee or worker or a person who is remunerated by the payer on a monthly basis, 0.5 percent of the remuneration of the person is quantified as amount derived from vehicle facility in the inclusions.
  - (b) Accommodation allowance may be replaced providing the use of resident facility. In a monthly basis, 2 percent of the salary

of the person is quantified as amount derived from accommodation facility in the inclusions.

(c) Tiffin allowance may be replaced by providing meals or refreshments provided in premises operated by or on behalf of an employer to the employer's employees that are available to all the employees on similar terms.

☐ Tax Planning in Individual's Consideration

(a) Maximization of deduction is available for investing in Citizen Investment Trust to make up to one third of the assessable income or Rs. 300,000 whichever is lower.

(b) Taxable income may be reduced from life insurance premium paid to insurance company. It may be reduced by 7 percent of the insured amount or Rs. 10,000 whichever is lower. It may be more beneficial for the insured amounting Rs. 143,000.

Calculation of tax liabilities after tax planning of an individual for the income year 2063/064

INCLUSIONS		**Amount**	**Amount**
1	Salary	300,000	
2	Fringe benefit for vehicle facilities (as a substitute of allowance)	1,500	
3	Fringe benefit for house facility (as a substitute of allowance)	6,000	
4	Retirement contribution paid by the employer	30,000	
Assessable income from employment		337,500	337,500
Assessable income			337,500
DEDUCTION FROM ASSESSABLE INCOME			
1	Contribution to retirement fund [both]	60,000	
2	Investment on CIT [own choice]	52,500	112,500
Taxable income			225,000
REDUCTION FROM TAXABLE INCOME			
1	Reductions: (1) Individual limit		100,000
2	(2) Life insurance premium		10,000
Total reduction from taxable income			110,000
Taxable income/base			115,000
CALCULATION OF TAX LIABILITIES			
	First limit Rs. 75,000 @ 15%		11,250
	In balance Rs. 40,000 @ 25%		10,000
CALCULATION OF ADDITIONAL TAX			

	1.5% of the taxable base Rs. 40,000	600
Tax liability		21,850
REDUCTION OF MEDICAL TAX CREDIT		
Medical tax credit [available upto 15% of the medical expenses or Rs. 750]		×
Tax liabilities or payable		21,850

Thus, tax planning if made by employer and employee considering the two way benefit then tax liabilities of employee can be reduced to Rs. 21,850 from Rs. 59,480.

REVIEW QUESTIONS AND CASES

1. Fringe benefits are the main factors of tax planning in employment income. Discuss.
2. Enumerate items of tax planning in individual income which can be planned own self.
3. A Lecturer of a Campus submitted his prospective income and expenses for this income year. The campus can provide alternative facility in the choice of taxpayer. Suggest for minimum tax liabilities.

Particulars	Alternate I	Alternate II
Salary for the year	200,000	200,000
Accommodation facility	Rs. 1,500 p/m	House facility
Transportation facility	Rs. 300 p/m	Vehicle facility
Chairmanship allowance	Rs. 500 p/m	Rs. 500 p/m
Salary in lieu of leave	Rs. 15,000 p/a	Rs. 15,000 p/a
Tiffin facility (equal Rs. 12,000 p/m)	In cash	In kind (similar basis)
House keeper	Rs. 2,500 p/m	Rs. 3,000 p/m
Life insurance premium paid by employer	Rs. 7,000	Rs. 10,000
Medical expenses by employer	Rs. 4,000	Rs. 5,000
Child education expenses paid by employer	Rs. 12,000 p/a	Rs. 14,000 p/a
Remote area allowance	Rs. 18,000 p/a	No any allowance

Additional information:

1. He is a member of the retirement fund to which he contributes 10% of his salary and the employer contributes the similar amount.
2. He lives nearly his workplace/office therefore; he does not incur any cost for transportation.

3. His dwelling is outside Valley, he pays Rs. 2,000 per month as rent now.
4. He incurs Rs. 9,000 in an income year for Tiffin expenses.

Required:

(a) Minimum tax liabilities [5]
(b) Amount of after tax earning [3]
(c) Which proposal is preferable and why? [2]

21.6.2 Self Employment

There are two types of employments: employment and self employment. The major distinction between these two employments is that the first works for another and later works for him.

☐ Concept of Self-Employment

Self employment denotes works for himself/herself instead of as an employee of another person or organization and drawing income from a trade or business. Sometimes, it is a precursor to form a small business with employees. Moreover, it may be established in different nature - as a sole proprietor, or an independent contractor or own vehicle driver in a small-scale. In case of self employment the individual and his business are one and of same existence. This makes the owner personally liable for all debts of the business. To avoid this, he may choose to incorporate his business, protecting his personal assets from creditors of others taking legal action against the business.

In Nepal, there are large numbers of self employment activities. Peddlers, who are working to sell goods, especially while traveling from place to place is a good example of self employed. Moreover, butchers, hair saloon, fruit shops, photocopy, stationery, vegetable shops public service corner, etc. which are operated including or excluding other person(s) also may fall under the self employment. Business which is operated in large scale under status of proprietorship may not be called self employment.

ITA 2002 provides some facilities to those self employed businesses taking into account their costs of compliance for tax purposes. These short processes certainly reduce the compliance costs of taxpayer. The self employed or small-scale businesses which are operated within metropolitan city, sub-metropolitan city, municipality or village development committee may entertain the following facilities.

☐ Presumptive Taxation

Presumptive taxation is a concept of taxation according to which income tax is based on 'average' income instead of actual income. The

presumptive taxation of income from business or investment is an alternative where it is difficult to tax actual income in case of professionals, the self-employed.

1. **General concepts:** Stern (as cited in Thuronyi, 1996) mentions, "Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts" *(Thuronyi)*. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of indirect method. Moreover, Lapidoth (as cited in Thuronyi, 1996) further justified - the concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.

   Thuonyi (1996) concludes, this concept does not cover all instances of the use of legal presumptions in taxation. More generally, a presumption can be said to be involved anytime a mechanical definition is used in place of a more open-ended rule based on the facts and circumstances of each case.

2. **Reasons of presumptive taxation:** In general, the presumptive taxation techniques have to be employed for a variety of reasons. The reasons may be listed as below:

   - **Simplification**: Simplification relates particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers).
   - **Combat tax avoidance or evasion:** The presumptive taxation combats to tax avoidance or evasion - which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records.
   - **Objective indicators**: The objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption.
   - **Rebuttable presumptions**: The rebuttable presumptions can encourage taxpayers to keep proper accounts, because they

subject taxpayers to a possibly higher tax burden in the absence of such accounts.

- **Presumptions of the exclusive type**: The presumptions of the exclusive type can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax.
- **Combination of reason**: The presumptions that serve as minimum taxes may be justified by a combination of reasons such as revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax.

Presumptive taxation can be used for any tax that is normally based on accounting records - income tax, excise tax, and sales or value-added tax. However, it is most commonly used for the income tax.

Withholding taxes are also presumptive taxes if they are final. Thuronyi, 1996 mentions that withholding taxes can also achieve the effect of taxation based on an alternative simplified base. Withholding is commonly used for the income tax and is usually based on the gross amount of a payment. Withholding can also be imposed on other bases, for example, on the amount of imported goods, with a credit allowed against income tax.

ITA 2002 has used the system of presumptive tax in small self-employment business. For this threshold of turnovers and profits are taken into consideration. A self employed having transaction turnover more than Rs. 1,500,000 and profit Rs. 150,000 can not treat for presumptive taxation. The basic criteria for presumptive taxations are:

1. If a resident individual's income for an income year consists exclusively of income from a business having sources in Nepal.
2. A resident individual that not having medical tax credit paid by the individual by him/herself or through others during the year in respect of the individual.
3. A resident individual not claiming tax credit as per §93.
4. If the individual selects that this provision applies for the income year.

Moreover, the presumptive taxes vary from business zones. These zones and the fixed presumptive taxation are given as under:

1. Within area of metropolitan and sub-metropolitan city Rs. 2,000
2. Within area of municipality Rs. 1,500.
3. Areas other than metropolitan and municipality Rs. 1,000

Similarly, the owners of vehicles on hire are kept under the presumptive taxation as annual tax at the rates given below. If the person is a natural person, then tax so paid are treated final and binding.

5. Minibus, mini-truck, truck and bus Rs. 1,500
6. Car, jeep, van, and microbus Rs. 1,200
7. Three-wheeler, auto-rickshaw, and tempo Rs. 850
8. Tractor and power tiller Rs. 750

3. Self employment other than presumptive taxation: A self-employed person who operates business transactions of more than Rs. 1,500,000 and gets profit more than Rs. 150,000 for an income year and maintains proper bookkeeping can claim and enjoy the following benefits:

- **Retirement contribution:** A self-employed can claim deduction of contribution to retirement fund not more than 1/3 of his assessable income or Rs. 300,000 if he contributed in the investment fund.
- **Reduction from taxable income:** A self-employed is entitled to reduce relief according to family status: individual or couple, life insurance premium (including pension income relief or remote area allowance relief; if applicable) from his taxable income.
- **Two tier tax rates:** A self-employed is entitled to get two tier tax rates like other taxpayers according to prevailing law.
- **Medical tax credit:** A medical tax credit is also available to self-employed if it is paid for approved medical treatment.

21.6.3 Capital Structure

Capital structure of a business refers to the way in which it is financed. In most of the cases, capital structure comprises a combination of long-term capital (e.g. ordinary shares, reserves, preference shares, debentures, long-term bank loans etc.) and short-term liabilities (such as a bank overdraft and trade creditors). It is important that a business is financed by an appropriate capital structure that reflects the nature of the business and its ability to generate profits and cash flow. For example, business at the startup or growth stage may not be profitable and may also have significant investment requirements. In this example, the appropriate capital structure would mainly comprise equity finance such as ordinary shares rather than bank debt (where the business would need to finance interest charges).

Leverage, generally refers to the use of debt in capital structure. The greater the use of debt, the more leverage the firm is using. Also, a firm

that has some degree of debt financing is sometimes called a levered firm. The leverage term is used because with large amounts of debt financing small changes in sales will lead to large changes in earnings per share. This arises because interest is a fixed cost item. If firm does well, we don't pay any more in interest. However, if firm does poor performance, don't pay any less in interest. While this is, what is generally meant by leverage? There are two other terms called the Degree of Operating Leverage (DOL) and Degree of Financial Leverage (DFL).

A debenture is a form of loan. It is a written acknowledgement of a debt by a business that normally containing provisions as to payment of interest and the terms of repayment of principal. A debenture may be secured on some or all of the assets of the business or its subsidiaries.

☐ Setting Capital Structure in Practice

Capital structure theory reports potential advantages and disadvantages of debt financing. Unfortunately, it does not report what debt/equity ratio should be for our firm. Instead, this is a decision made primarily by experience and judgment. Key things that are considered in coming to this decision include:

1. **Risk:** It is critical in that firms with high levels of business risk are going to feel the impact of financial distress costs at much lower debt levels than firms with low levels of business risk. Because of this, we tend to see firms with lower levels of business risk use more debt than firms with high levels of business risk.

2. **Taxes**: It is also an important consideration. One of the key advantages to debt is the tax benefits. If a firm has low or negative earnings or other tax shields (high levels of depreciation), it may not be able to take full advantage of the tax benefits of debt. Therefore, firms with high taxable earnings are more likely to use debt financing than firms with low levels of taxable earnings.

3. **Financial Slack**: It is also important. Firms that anticipate the need for high levels of borrowing in the near future will want to maintain lower levels of debt currently. This will allow them to tap their credit sources when necessary.

4. **Industrial Norms**: Firms also tend to follow Industry Norms when setting capital structures. Firms within the same industry tend to have similar capital structures. Part of this is related to business risk. However, firms have to be careful not to blindly "follow the

leader" and to instead make sure there is a rational justification for their capital structure position beyond industry norms.

5. Lender Standard: Firms also tend to observe Lender Standards. To the extent that they anticipate future borrowing needs, firms will want to make sure they are attractive in the eyes of potential lenders and not appear too risky. This will make it easier for them to obtain more debt later at reasonable interest rates.

Under the capital structure decision, the decision is taken for the amount of loan to obtain the maximum profit for the return on equity (ROE). The ROE is a measure of investment return that compares the profit earned by a business with the amount invested in the business by shareholders. Thus, in tax planning the capital structure decision plays a vital role to decide the combination of the capital to earn required rate of return on equity.

☐ Interest Deduction Provision

According to ITA 2002, the interests of the borrowed funds are allowed to be deducted if incurred in course of conducting a business or investment. The borrowed funds, for which interests are paid, should be used in that production or used to acquire an asset used in that production. Thus, the loan is to satisfy the following states to deduct its interests from the business or investment income.

1. The borrowed money must be used during the year;
2. The borrowed fund must be used to purchase an asset that is used during the year; or
3. In any other case, the debt obligation was incurred.

Generally, financial risk is the risk placed on the common shareholders as a result of the decision to use debt financing, or financial leverage, in the capital structure. Management is therefore interested in determining the amount of debt or financial risk that maximizes return on equity. The impact of return on equity through the debt capital may be affected as given below:

EXAMPLE 21-44 A Corporation has Rs. 200,000 in assets and is all equity financed. Assuming an earning before interest and taxes (EBIT) of Rs. 40,000, the rate of return on equity (ROE) is computed as follows:

	Earning before interest and taxes [EBIT]	40,000
Less	Interest	0

	Earning before tax [EBT]	40,000
Less	Taxes 20%	8,000
	Net income	32,000
	Return on equity [ROE] [Rs. 32,000/Rs. 200,000×100]	16%

The above example depicted that the ROE for the equity capital is 16%.

EXAMPLE 21-45 Assume that the Corporation decides to issue Rs. 100,000 of debt at an interest rate of 10% to be used to retire Rs. 100,000 of common stock. The ROE will be as follows:

	Earning before interest and taxes [EBIT]	40,000
Less	Interest [10% on Rs. 100,000]	10,000
	Earning before tax [EBT]	30,000
Less	Taxes 20%	6,000
	Net income	24,000
	Return on equity [ROE] [Rs. 24,000/Rs. 100,000x100]	24%

The above example revealed that the use of financial leverage increased ROE from 16% to 24%. One can expect firms to continue to increase leverage and increase the ROE to stockholders. The fact is that the improvement depends on the return on assets, as measured by EBIT/total assets, being higher than on the interest rate of debt. For this purpose:

EXAMPLE 21-46 Suppose that EBIT was Rs. 20,000 rather than Rs. 40,000. The ROE would be calculated as follow:

	Earning before interest and taxes [EBIT]	20,000
Less	Interest [10% on Rs. 100,000]	10,000
	Earning before tax [EBT]	10,000
Less	Taxes 20%	2,500
	Net income	7,500
Return on equity [ROE] [Rs. 7,500/Rs. 100,000×100]		7.5%

With lower rate of return on assets, the ROE with 50% financing declined from 24 percent to 7.5%. Although there may be an optimal capital structure that maximizes ROE, the use of financial risk

increases the risk faced by equity investors and depends on whether the return on assets exceeds the interest rate on debt.

EXAMPLE 21-47 Suppose that a corporation is all equity financed and has 200 shares selling for Rs. 20 per share. It plans to issue Rs. 2,000 worth of debt and use the proceeds to give a Rs. 10 cash dividend per share. Management expects the market value of the firm to either stay the same or increase or decrease by Rs. 500. The potential capital structures are as follows:

Firms value and capital structure		Debt + Dividends Scenarios		
	Capital structure	1	2	3
Debt	0	2,000	2,000	2,000
Equity	4,000	2,500	2,000	1,500
Firm value	4,000	4,500	4,000	3,500
The payoff to stockholders under the three scenarios are as follows:				
Capital gains	-	(1,500)	(2,000)	(2,500)
Dividends	-	2,000	2,000	2,000
Net gain or loss to equity holders		500	-	(500)

Obviously, the capital structure that maximizes firm value occurs under scenario 1. If management expected scenario 1 to happen, then the restructuring of capital structure is a good idea. It is a bad idea if scenario 3 was expected.

CASES AND SOLUTIONS

1. Nepal Ltd. is a listed non-industrial public limited company. It has three proposals to expand its adequate capacity. The following investment proposals are available for this purpose:

Capital structure	Proposal I	Proposal II	Proposal III
Share capital	20,000,000	10,000,000	4,000,000
Debenture: 15% interest	Nil	4,000,000	4,000,000
Bank loan: 20% interest	Nil	6,000,000	12,000,000
Total fund	20,000,000	20,000,000	20,000,000

Expected rate of return (before tax) is 40 percent. It has been paying dividends at around 60 percent from last 10 years. What would be the optimal capital structure to obtain the rate of past dividend?

Solution:

Calculation of earning after tax (EAT) and rate of return on equity capital (ROE) under various alternative capital structures:

Particulars	Proposal I	Proposal II	Proposal III
EBIT	8,000,000	8,000,000	8,000,000
Less: Interest			
Debenture	-	(600,000)	(600,000)
Bank loan	-	(1,200,000)	(2,400,000)
Taxable profits	8,000,000	6,200,000	5,000,000
Less: tax at 25%	(2,000,000)	(1,550,000)	(1,250,000)
Profit after tax [PAT]	6,000,000	4,650,000	3,750,000
Rate of return on equity capital	30%	46.5%	93.75%

Decision: As revealed on the above calculation, only the third proposal satisfies the criteria of maintaining past dividend rates. Further bringing down the equity investment from the level proposed in the third alternative could still increase the rate of return. Moreover, return on any equity investment below 20 percent is considered too risky and therefore not advisable.

2. Kathmandu Ltd. has four proposals to expand its adequate business capacity.

Capital structure	Proposal A	Proposal B	Proposal C	Proposal D
Share capital	300,000	200,000	100,000	50,000
15% Debenture	-	100,000	-	
20% Bank loan	-	-	200,000	
25% Private loan	-	-	-	250,000
	300,000	300,000	300,000	300,000

The average rate of return on capital employed is 35 percent. It had been paying 40 percent dividend to its shareholders from last 3 years. What would be the optimal capital structure?

Solution:

Calculation of earning after tax (EAT) and rate of return on equity capital (ROE) under various alternative capital structures:

Particulars	Proposal A	Proposal B	Proposal C	Proposal D
EBIT	105,000	105,000	105,000	105,000
Less: Interest				
Debenture	-	(15,000)	-	-
Bank loan	-		(40,000)	-
Private loan	-			(62,500)

Taxable profits	105,000	90,000	65,000	42,500
Less: tax at 25%	26,250	22,500	16,250	10,625
Profit after tax [EAT]	78,750	67,500	48,750	31,875
Rate of return on equity	26.25	33.75	48.75	63.75

Decision: As depicted in the above calculation, only proposal C and proposal D maintain the past dividend. However, the proposal D is more beneficial than proposal C since its rate of return on equity capital is 63.75 percent.

3. A company has the following four alternatives capital structure to avail funds for its expansion program.

Capital structure	Alternative 1	Alternative 2	Alternative 3	Alternative 4
Equity Rs.	1,000,000	600,000	-	-
9% Debenture	-	400,000	500,000	-
12% Bank loan	-	-	500,000	600,000
20% Private loan	-	-	-	400,000
Total fund	1,000,000	1,000,000	1,000,000	100,000

The company has expected profit of Rs. 6,000 per day before charging interest and depreciation from the present scheme. At present, the firm is bearing a loss of Rs. 2,000 per day. The new asset that falls under group D profit could be reaped from the date of its commercial operation.

The dealer has agreed to supply the plant on 60 days credit and subject to payment within credit period. Installation work would be completed in 30 days for its commercial operation. Assume that the supplier paid within the credit period.

The Account Department informed that it takes normally one and half months to avail fund either by issuing share or debenture whereas it takes 15 days and 7 days only to obtain the fund from bank and or private money lenders respectively.

The corporate tax rate is 20%. Assume 360 days in a year.

Required:

Suggest to the management which alternative is best one from the point of view of a tax planner. [8]

Solution:

Pre-requisite assumption:

According to questions all fund may be available within two months credit period. Thus, we have to assume that all funds are taken at the ultimate date considering its cost.

Calculation of earning after tax (EAT) and rate of return on equity capital (ROE) under various alternative capital structures:

Particulars	Proposal A	Proposal B	Proposal C	Proposal D
EBIDT	1,980,000	1,980,000	1,980,000	1,980,000
Less:				
Loss	60,000	60,000	60,000	60,000
Depreciation	150,000	150,000	150,000	150,000
Interest: (a) Debenture	-	30,000	37,500	-
(b) Bank loan	-	-	50,000	60,000
(c) Private loan	-	-	-	66,667
Total deduction from EBIDT	210,000	240,000	297,500	336,667
Taxable profits	1,770,000	1,740,000	1,682,500	1,643,333
Less: tax at 20%	354,000	348,000	336,500	328,667
Earning after tax [EAT]	1,416,000	1,392,000	1,346,000	1,314,666
ROE	141.6	232	Inf.	Inf.

Decision: As depicted in the above calculation, proposal C is the best alternative for the tax purposes to obtain the rate of return.

4. A Company estimated a capital outlay of Rs. 1,000,000 for its expansion program. Company's advisor has suggested the following four alternatives.

Particulars	Alternate1	Alternate2	Alternate 3	Alternate 4
Share capital	1,000,000	500,000	400,000	-
7% Debenture	-	500,000	400,000	-
15% Term loan	-	-	200,000	500,000
24% Private loan	-	-	-	500,000
Total	1,000,000	1,000,000	1,000,000	1,000,000

The company expects a net income of Rs. 4,000; before charging interest and the cost of financing expenses scheme, a day from this expansion program from the date of its commercial operation. The dealer agreed to extend 60 days credit to supply the machine subject to payment is made within the credit period. At present, the company is incurring a loss of Rs. 1,000 a day. Experience shows that it takes normally one and half months to obtain fund either from issuing shares or debentures, whereas

it takes 15 days and 5 days to avail funds from bank or private moneylenders respectively. Extension works would be completed within 15 days for its commercial production. Loan will be retired on the very day of operation. Company incurred 2% scheme expenses (assume revenue) to raise fund from share and debenture. The corporate tax rate is 20%. Assume 360 days a year.

Required:

Which alternative is preferable and why? [8] [MBS 2060, TU, modified]

Solution:

According to the question all fund may be available within two months credit period. Thus, we have to assume that all funds are taken at the ultimate date considering its cost.

Particulars	Proposal A	Proposal B	Proposal C	Proposal D
EBIT	1,380,000	1,380,000	1,380,000	1,380,000
Less:				
Loss	15,000	15,000	15,000	15,000
Capital raising costs	27,600	27,600	27,600	
Interest (a) Debenture	-	29,167	23,333	
(b) Bank loan	-	-	25,000	62,500
(c) Private loan	-	-	-	100,000
Total deduction from EBIT	42,600	71,767	90,933	177,500
Taxable profits	1,337,400	1,308,233	1,289,067	1,202,500
Less: tax at 20%	267,480	261,647	257,813	240,500
Earning after tax [EAT]	1,069,920	1,046,586	1,031,254	962,000
ROE	107%	209%	257%	Inf.

Decision: As depicted in the above calculation, proposal D is the best alternative for the tax purposes to obtain the rate of return.

REVIEW OF QUESTIONS AND CASES

1. Capital structure is one of the best tools of tax planning. Explain.
2. A company requires Rs. 1,000,000 capital outlay for its expansion purpose. The expansion will give the company a net income of Rs. 2,000 per day [purely from expanded activities]. It can raise its capital either by issuing new shares or floating 8% debenture or borrowing from financial institutions at 16% p.a. interest or from indigenous bankers at 24% p.a. Flotation cost is one percent of the capital outlay for both new shares and debentures. Normally, it takes 3 months to avail capital by floating new shares, and one month by issuing debenture. Loan can be obtained from banks within 15 days

whereas it takes only 2 days to obtain from indigenous bankers. The company, at present, incurring a loss of Rs. 500 per day from the current business which alternative is preferable to the company if the corporate tax rate is 30% assuming 360 days a year. [10]

[MBA. 2054 TU]

3. A company has the following four alternative capital structures:

	1	2	3	4
Equity	Rs. 100,000	Rs. 80,000	Rs. 50,000	Rs. 20,000
Loan	-	20,000	50,000	80,000
Total	100,000	Rs. 100,000	Rs. 100,000	Rs. 100,000

The average rate of return on capital employed is 30% and required rate of return on loan is 15%. If the Income Tax rate is 30% what would be the optimal capital structure from the point of view of tax planning? [10]

4. A company requires Rs. 1,000,000 capital outlay for its expansion purpose. The expansion will give the company a net income of Rs. 3,000 per day after extension work is completed. The company has different alternatives to raise capital. It can raise its capital either by issuing new equity capital or by issuing 6% debenture or borrowing from financial institutions at 16% p.a. or borrowing from private money lender at 30% p.a. The floatation cost is one percent for both new shares and debentures. However, the company has to incur two percent as brokerage charge to obtain loan from financial institutions. Normally it takes 3 months to avail capital by issuing new shares and one month by issuing debenture. Loan can be obtained from financial institutions within 20 days, whereas it takes only 3 days to obtain it from private lenders. At present the company is incurring a loss of Rs. 1,000 per day. It takes only 15 days to complete extension work. The corporate tax rate is 30%. Assume 350 days a year.

Required:

Which alternative is preferable to the company and why? [10]

[MBA, 2056, TU, modified]

5. A company needs Rs. 1,000,000 capital fund for its expansion purpose. The company wants to carryout the program immediately in the following fiscal year. The anticipated net income, before charging interest, tax and other related expenses, of Rs. 2,000 per day since the completion of extended work. The company has the following alternative at present:

Alt 1: Issuing Equity Shares

Alt 2: Issuing 12% debenture

Alt 3: Loan from Financial Institution at 18% p.a. interest.

Company must incur 3% floatation cost on issuing of both share capital as well as debenture. Bank charges three percent commission on loan. In spite of the financial advisor's advice to obtain loan by issuing the debenture, the management decided to avail the fund from financial institution on the ground that earliest the fund earliest the operation. Evidence shows that Bank loan could be availed on the 15^{th} day from the date of application whereas it takes two months and one month by issuing shares and debentures respectively. At present the company is incurring a loss of Rs. 1000 per day. As the new machine is available locally, it could be installed and put into operation from the 15^{th} day of the availability of the fund. Assume 360 days average in a year and corporate tax rate is 20% and current extensions increases only 20% in the production capacity.

Required:

As a tax planner which alternative is preferable to the company and why? (Ignore depreciation of the assets) [6]

6. A Company estimated a capital outlay of Rs. 1,000,000 for its expansion program. Company's advisor has suggested the following four alternatives.

	Alternate1	Alternate2	Alternate 3	Alternate 4
Share capital Rs.	1,000,000	500,000	400,000	-
7% Debenture	-	500,000	400,000	-
15% Term loan	-	-	200,000	500,000
24% Private loan	-	-	-	500,000
Total	1,000,000	1,000,000	1,000,000	1,000,000

The company expects a net income of Rs. 4000; before charging interest and the cost of financing expenses scheme, a day from this expansion program from the date of its commercial operation. The dealer agreed to extend 60 days credit to supply the machine subject to payment is made within the credit period. At present the company is incurring a loss of Rs.1000 a day. Experience shows that it takes normally one and half months to obtain fund either from issuing shares or debentures, whereas it takes 15 days and 5 days to avail funds from bank or private moneylenders respectively. Extension works would be completed within 15 days for its commercial production. Loan will be retired on the vary day of operation. Company incurred two percent scheme expenses (assume revenue) to

raise fund from share and debenture. The corporate tax rate is 20%. Assume 360 days a year.

Required:

Which alternative is preferable and why? [8] [MBS, 2060, TU, modified]

7. A company has the following form of alternative capital structure to avail funds for its expansion program.

Particulars	Alternative 1	Alternative 2	Alternative 3	Alternative 4
Equity Rs.	1,000,000	600,000	-	-
9% debenture	-	400,000	500,000	-
12% bank loan	-	-	500,000	600,000
20% Private Loan	-	-	-	400,000
Total Fund	1,000,000	1,000,000	1,000,000	100,000

The company has expected profit of Rs. 6,000 per day before charging interest and depreciation from the present scheme. At present, the firm is bearing a loss of Rs. 2,000 per day. The new asset falls under group D. Profit could be reaped from the date of its commercial operation.

The dealer has agreed to supply the plant on 60 days credit subject to payment within credit period. Installation work would be completed in 30 days for its commercial operation. Assume that the supplier is paid within the credit period.

The Account Department informed that it takes normally one and half months to avail fund either by issuing share or debenture whereas it takes 15 days and 7 days only to obtain the fund from bank and or private moneylenders respectively.

The corporate tax rate is 20%. Assume 360 days in a year.

Required:

Suggest the management which alternative is best one from the point of view of a tax planner. [8] [MBS, 2061, TU, modified]

8. A limited company requires 1,000,000 capital outlays for its expansions programs.

Particulars	1	2	3	4
Equity	Rs.1000000	400000	500000	700000
Bank loan	....	600000	....	....
Debenture loan	....	....	500000	....
Personal loan	....	....	....	300000
Total fund	Rs.1000000	1000000	1000000	1000000

Required:

The average rate of return (EBTT) on capital employed to be 28% of the outlay.

Income Tax rate is 20%

Optimal capital structure from the point of view of tax planning if

a) Required rate of return on all type of loan is 20%.
b) Required rate of return on bank loan, debenture loan and personal loan are 15%, 17% and 18% respectively (3+3)

21.6.4 Industrial Location Selection

Industrial location decisions can have a major impact on future costs and revenues a firm will generate. Overall, firm cost savings available at alternative locations need to be carefully examined in addition to a location's impact on industrial sales revenues.

Some industrial costs vary across geography. For example, wages, taxes, rental rates, utilities, raw materials, components and transportation costs can vary significantly. At first glance, one may assume that locating to a lower cost area will always enhance investor's return. Moreover, industrial profitability is affected by differences in sales volume and prices as well as cost differences across space.

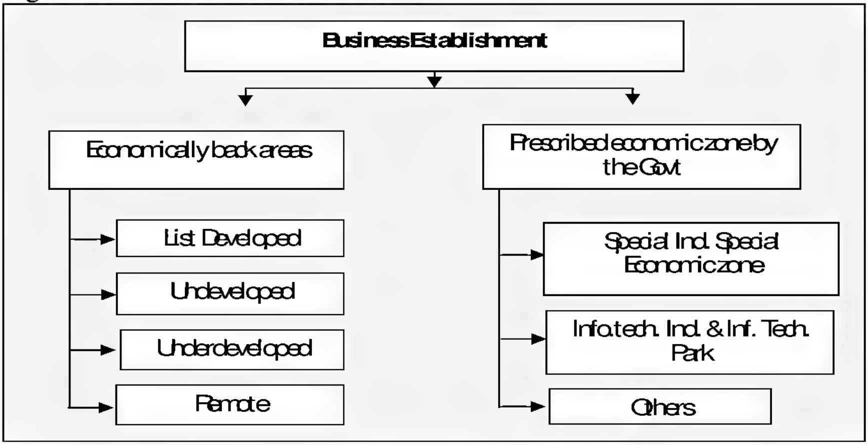
Location choice influences the indirect and direct cost savings. Direct cost savings are more readily quantified and include lowering expenses: taxes, wages, utilities, other overhead expenses and transportation costs. Similarly, indirect cost benefits include: salary, general office supplies, communication expenses etc.

Corporate location decisions can have a significant impact on investor wealth. Important expense and revenue factors should be considered when making location decisions.

□ Tax planning and location decision in Nepal

ITA 2002 maintains two types of business locations 惘Geographical and Economic Zone 惘to privilege tax.

Figure 21.2: Business establishment



☐ Economically Back Areas

Economically back areas are divided into three groups: least developed, undeveloped, and under-developed.

A special industry of a person if it operated in a remote (least developed), undeveloped or an underdeveloped area, tax is levied at 70 percent, 75 percent and 80 percent respectively of the rate otherwise applicable for the period of 10 income years commencing from and including the year in which the operation commenced.

Similarly, ITA 2002 also maintains a provision of remote area allowance upto Rs. 30,000 to an individual working in prescribed remote areas. The remote area allowance is divided into 5 classes according to their remoteness as A, B, C, D, and E and these are facilitated by Rs. 30,000, Rs. 24,000, Rs. 18,000, Rs. 12,000 and Rs. 6,000 respectively.

☐ Prescribed Economic Zone

Business established or located in special economic zone are provided income tax concessions.

☐ Income of an Export Business

Income of an export business or industry or business operated in particular zone also fall under the income tax concessions.

☐ Export Promotion and Special Economic Zone

Income derived from export promotion sector prescribed by the Government of Nepal or special industry established in special economic zone is taxed at 50 percent of the rate_otherwise applicable to the income of that year.

☐ Information Technology Intensive Industry

An industry, if it is information technology intensive industry and has been established within Information Technology Park prescribed by the Government of Nepal, the tax is levied 25 percent of the rate otherwise applicable to the income of that year.

A natural person if involves in operating special industry throughout the year or an entity involves in special industry to export the goods or involves in infrastructure works is taxed 75 percent of the rate otherwise applicable to the income of that year.

CASES AND SOLUTIONS

1. A limited company wants to invest in a capital outlay of Rs. 1,000,000 in a Juice Factory.

The company expects the following profit before depreciation, transportation cost and tax.

Year	1	2	3	4	5
Profit(Rs.)	200,000	300,000	400,000	200,000	150,000

The company management has preferred Kathmandu as a plan to set up the factory. However, considering the facilities extended by the ITA 2002 localization in other part also cannot be ignored. Company has considered Sindhuli and Kalaiya as other two alternative locations. The ITA 2002 has provided the following concessions for location at different places.

1. No rebate will be allowed if factory is located in Kathmandu,
2. 20 percent rebate will be extended if it is located in any part of Terai region, and
3. 80 percent rebate for first 2 years and 20 percent concession for another 3 years if located in hilly regions.

Kathmandu is the major market for this product and hilly regions are the major suppliers of inputs. The anticipated production and sale of the factory will be 10,000 bottles of finished goods of 1 liter each 10 Kg of input will be required to produce one bottle of finished product. Assume the factory runs throughout the year with targeted capacity. Consider the following further information.

Alternative- I:

If factory is located in Kathmandu

(a) 80 percent of input will supplied from hilly regions and balance 20 percent will be available locally.

(b) Road will be the means of transport.

(c) Average transportation cost per 10 KGs of input is Rs. 4

Alternative II:

If Factory is located in Kalaiya

(a) 60 percent of input will supplied from hilly regions and balance 40 percent will be available locally.
(b) Road will be the means of transport.
(c) Transportation cost per 10 KGs of input is Rs. 2
(d) Transportation cost of finished product to Kathmandu will be Rs. 2 per bottle.
(e) Transportation cost of finished product to Kathmandu will be Rs. 2 per bottle.

Alternative III:

If factory is located in Sindhuli

(a) Raw inputs will be available locally.
(b) Road will be the means of transport.
(c) Transportation cost of finished product to Kathmandu by road will be Rs. 2 per bottle.

Required:

As a tax planner, which alternative is the best from the point of view of tax? Charge depreciation at the rate one percent per annum.

[MBS 2060 New TU]

Solution:

Alternate I:

If the factory is located in Kathmandu

Output 10,000 bottles. Input supply from hilly region to Kathmandu 80,000 Kgs

Particulars	Year					
	1	2	3	4	5	Total
Profit before transportation cost, depreciation and tax	200,000	300,000	400,000	200,000	150,000	1,250,000
Less:						
Transportation cost for input	(32,000)	(32,000)	(32,000)	(32,000)	(32,000)	(160,000)
Transportation cost for output	0	0	0	0	0	0
Depreciation allowance	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(50,000)
Profit before tax	158,000	258,000	358,000	158,000	108,000	1,040,000
Income tax [20% tax rate]	(31,600)	(51,600)	(71,600)	(31,600)	(21,600)	(208,000)
Profit after tax	126,400	206,400	286,400	126,400	86,400	832,000

Alternate II:

If the factory is located in Kalaiya

Output 10,000 bottles. Input supply from hilly region to Kalaiya 60,000 KGs and output supply to Kathmandu 10,000 bottles

Particulars	Year					
	1	2	3	4	5	Total
Profit before depreciation transportation cost and tax	200,000	300,000	400,000	200,000	150,000	1,250,000
Less:						
Transportation cost for input	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(60,000)
Transportation cost for output	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(100,000)
Depreciation allowance	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(50,000)
Profit before tax	158,000	258,000	358,000	158,000	108,000	1,040,000
Income tax [80% of 20]	(25,280)	(41,280)	(57,280)	(25,280)	(17,280)	(166,400)
Profit after tax	132,720	216,720	300,720	132,720	90,720	873,600

Alternative III:

If the factory is located in Sindhuli

Output 10,000 bottles. Input available locally and output supply to Kathmandu 10,000 bottles.

Particulars	Year					
	1	2	3	4	5	Total
Profit before depreciation, transportation cost and tax	200,000	300,000	400,000	200,000	150,000	1,250,000
Less:						
Transportation cost for input	0	0	0	0	0	0
Transportation cost for output	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(100,000)
Depreciation allowance	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(50,000)
Profit before tax	170,000	270,000	370,000	170,000	120,000	1,100,000
Income tax [80% of 20]	(6,800)	(10,800)	(59,200)	(27,200)	(19,200)	(123,200)
Profit after tax	163,200	259,200	310,800	142,800	100,800	976,800

Since the total profit after tax from the five years is Rs. 976,800 from Sindhuli. It is a most beneficial location among the available alternates. Thus, it is recommended to establish factory in Sindhuli.

REVIEW QUESTIONS AND CASES

1. A limited Company contemplates to invest a capital outlay of Rs. 1,000,000 in carpet industries. The Company expects the following profits before tax and without considering transportation cost.

Year	1	2	3	4	5
PBT(Rs)	400,000	300,000	500,000	600,000	700,000

Government does not prohibit locating factory anywhere but the ITA (assumed) has provided the following rebates and tax holidays for location at various places.

1. No rebate and concession if the factory is located in Kathmandu,
2. A 20% rebate is extended if set up in any district of underdeveloped areas,
3. A 100 rebate for first 2 years and 25% rebate for another 3 years if established in undeveloped areas, and
4. A 100% rebate for first 2 years and 30% rebate for another 3 years in remote areas.

Kathmandu would be major market of finished product and remote area would be the major supplier of raw-materials. If industries are located in Kathmandu or Underdeveloped areas or undeveloped area, the required raw-material to be supplied from remote area would be as follows.

To Kathmandu 100%
To Underdeveloped area 80%
To Undeveloped area 50%

The demand and supply of this product is 10,000 square meter per year. To produce 1 square meter of Carpet one Kg of raw-material is required. The transportation cost per 10 Kg of raw-materials is Rs. 3, Rs. 2 and Rs. 1 to Kathmandu, underdeveloped areas and undeveloped areas respectively. However, if the product is supplied to Kathmandu the transportation cost per 200 Sq. meters would be Rs. 20,000, Rs. 3,000 and Rs. 4,000 from underdeveloped area, undeveloped area and remote area respectively. The average capacity of the factory is 50 trucks of 200 Sq. meters each.

Required:

As a tax planner, where would you recommend to locate the factory showing details of calculation? The appropriate tax rate is 20%. [6] [MBA, TU]

2. A Ltd. Company wants to invest a capital outlay of Rs. 1,000,000 in an Herbs Processing Factory. The company anticipates the following profit before tax and before considering the transportation cost.

Year	1	2	3	5	6
Profit (Rs.)	300,000	400,000	500,000	300,000	400,000

The government has extended a liberal policy to set-up such industry anywhere but the Industrial Enterprise Act has provided the following rebates and concessions for location at different places.

(a) No rebate is allowed if the factory is located in Kathmandu.
(b) A 25% rebate is extended, if it is setup in any part of Terai.
(c) 100% rebate for first 2 years and 60% concession for another 3 years if located in remote areas.

The company has selected three location viz. Kathmandu, Nepalgunj and Jumla but has preferred Kathmandu as best one. Remote area is the major supplier of input material whereas Kathmandu is the major market for its product. The budgeted production and sale of factory is 20,000 bottles of finished goods of 200ml each. To produce 1 bottle finished goods 10 Kg of input is required. This target could be run at this capacity for the whole year.

Alternate 1:
If the factory is located in Kathmandu
(a) All inputs will be supplied to Jumla
(b) Air is the only means of transport
(c) Transportation cost of per kg of input is Rs. 15

Alternate 2:
If factory is located in Nepalgunj
(a) 80% inputs will be supplied to Jumla and the balance 20% is available locally
(b) Air is the only means to transport raw inputs
(c) Transportation cost per kg of input is Re. 1
(d) Transport of finished product to Kathmandu by bus costs. Re. 1 per bottle

Alternate 3:
If factory is locate in Jumla
(a) Air is the only means of transport

(b) Transportation cost of Rs.5 per bottle.

Required:

As a tax planner, which alternative would be the best one from the point of view of tax? Assume depreciation of assets has already been adjusted in above profit. [6]

3. A Ltd. Company wants to invest in a capital outlay of Rs. 1,000,000 in a Juice Factory. The company expects the following profit before depreciation transportation cost and tax.

Year	1	2	3	4	5
Profit (Rs.)	200,000	300,000	400,000	200,000	150,000

The company management has preferred Kathmandu as a plan to set up the factory. However the considering the facilities extended by ITA localization in other part also cannot be ignored. Company has considered Sindhuli and Kalaiya as other two alternative locations. The ITA has provided the following concessions for the location at different places.

1. No rebate will be allowed if factory is located in Kathmandu.
2. 20% rebate will be extended, if it is located at any part of Terai region, and
3. 80% rebate for first 2 years and 20% concession for another 3 years if located at hilly regions.

Kathmandu is the major market for this product and hilly regions are the major supplier of inputs. The anticipated production and sale of the factory will be 10,000 bottles of finished goods of 1 liter each. 10 Kg of input will be required to produce one bottle of finished product. Assume the factory runs throughout the year with targeted capacity. Consider the following further information.

Alternate 1:

If factory is located in Kathmandu

(a) 80% of inputs will be supplied from hilly regions and balance 20% will be available locally

(b) Road will be the means of transport

(c) Average transportation cost per 10 Kg of input is Rs. 400

Alternate II:

If factory is located in Kalaiya

(a) 60% inputs will be supplied from hilly regions and balance 40% will be available locally.

(b) Road will be the means of transport.
(c) Transportation cost of 10 Kg of input is Rs.2.
(d) Transportation cost of finished product to Kathmandu will be Rs. 2 per bottle.

Alternate III:

If factory is located in Sindhuli

(a) Raw inputs will be available locally
(b) Road will be the means of transport
(c) Transportation cost of finished product to Kathmandu by road will be Rs.2 per bottle

Required:

As a tax planner, which alternative is the best from the point of view of tax. Charge depreciation at the rate of one percent per annum. [6]

[Master, TU]

4. A Co. Ltd. wants to invest a total capital of Rs. 1,000,000 in a shoe factory. The company expects the following profits before depreciation, transportation cost and tax.

Year	1	2	3	4	5
Profit (Rs.)	150,000	200,000	300,000	400,000	300,000

The company has considered Kathmandu, Dharan and Dailekh, the three alternative locations, to install the factory.

Consider the following concession and rebate as provided by the ITa before the installment of machine

(a) No rebate will be allowed if factory is located at Kathmandu.
(b) 10% rebate on tax will be allowed if it is located in any part of Terai.
(c) 60% rebate for the first two years and 10% rebates for another 2 years, if it is located in hilly region.

Kathmandu is the major market of this product and hilly regions are the major suppliers of raw inputs. Company's expected production and sales is Rs. 50,000 pairs of different sizes of shoes. On an average two square feet of leather required to make a pair of shoe irrespective of their size. Assume that the company achieved both production and sale target and there is no stock at the end.

Further Information

Alternate -I

If the factory is located in Kathmandu

a) All inputs will be supplied from hilly regions.
b) Road will be the means of transport.
c) Average transportation cost per 10 sq. ft. of leather is Rs.5.00

Alternate – II

If the factory is located in Dharan

a) 80% of inputs will be supplied from hilly regions and balance 20% is available locally.
b) Road will be the means of transport.
c) Average transportation cost per 10 sq. ft. of leather is Rs.20.
d) Transportation cost of finished product to Kathmandu will be Rs. 0.50 per pair.

Alternate –III

If factory is located in Dailekh

a) 80% of the raw inputs will be available locally and balance 20% will be supplied from Terai.
b) Road will be the means of transport.
c) Average cost of inputs collection from the surrounding collection centre is Rs. 1.00 per 10 Sq.ft.
d) Transportation cost of finished product to Kathmandu by road will be Rs. one per pair.

Required:

As a tax planner, which alternative is the best from the point of view of tax? Charge 15% p.a. depreciation of plant. Assume corporate tax rate is 20%. [2+2+2]

21.6.5 Outright Purchase or Hire Purchase

Outright purchase is acquiring assets or capital for cash or by bank loan, etc. Thus, it needs cash or bank loan for immediate payment.

Hire purchase is a method of buying goods in which the purchaser takes possession of the goods as soon as an initial installment of the price (a deposit) has been paid. The purchaser only obtains ownership of the goods when all the agreed number of subsequent installments are paid. A hire purchase agreement usually includes an option to purchase at the end of an initial period. Payment of this nominal fee transfers title of the asset and brings the legal agreement to an end.

EXAMPLE 21.48 A person purchases a vehicle on July 1 doing an agreement to pay it in 12 installments on July 1. According to the agreement the person used it since the date of initial installment

which is paid on July 1. If transfer of the ownership is after end of the 12 installments of the next year that is called hire purchase.

Accounting treatment of outright purchase significantly differs from hire purchase. In outright purchase the asset is capitalized in the balance sheet and an annual charge for depreciation is deducted as an expense in the profit and loss account, which in turn reduces the value of the asset in the balance sheet.

Similarly in hire purchase the asset is treated as if it had been purchased. It is, therefore, capitalized in the balance sheet and depreciation is provided on an annual basis. The obligation to pay future installments is recorded as a liability in the balance sheet. The payments are apportioned between a finance charge and a reduction of the outstanding liability. The total finance charge should be allocated to accounting periods during the HP term and is shown as an expense in the profit and loss account.

CASES AND SOLUTIONS

1. A limited special industry is negotiating to purchase a machine with an Indian manufacturer. The manufacturer is also interested in supplying the machine on hire purchase basis. The terms of sale offered by the manufacturer is total cost of Rs. 450,000 payable in 5 annual installments (free of interest) amounting Rs. 90,000 each, the payment made on July 17, and each year beginning with 2006. If the factory decides to take the machine on hire it has to pay annual rent amounting Rs. 70,000 each year on July 17 beginning from 2006. The factory purchases to use the machine for 8 years from 2006.

The following additional information is also available:

1. Income tax is payable at a proportional rate 20 percent as a special industries.
2. The factory has adopted method of depreciation as prescribed by tax law.
3. Being an industry, the factory is entitled to depreciation allowance for additional 1/3 of the 15 percent normal rate per annum.
4. The machine is being purchased in the course of replacement of existing machine and no increase in the existing installed capacity is involved.
5. Assume that the cost of capital of 15 percent. The machine is not expected to get any salvage value at the end of 8^{th} year.

Solution:

The tax implications/ suggestions of the alternative proposals can be ascertained as follows:

Table-1: Present value of cash outflow on account of installment payments

Date of payment	Amount of installment	Discount factor	PV (discounted at 15% to nearest 100)
July 17, 2006	90,000	1.0000	90,000
July 17, 2007	90,000	0.8696	78,264
July 17, 2008	90,000	0.7561	68,049
July 17, 2009	90,000	0.6575	59,175
July 17, 2010	90,000	0.5718	51,462
	450,000		346,950

Table-2: Tax savings on depreciation, tax rate: 20 percent, depreciation rate: 20 percent (15+1/3 of 15) and cost: Rs. 450,000.

Year	Value of machine	Amount of Depreciation	Tax savings on depreciation (20%)	Discount factor	PV of tax savings (Discount rate 15%)
1	450,000	90,000	18,000	1.0000	18,000
2	360,000	72,000	14,400	0.8696	12,522
3	288,000	57,600	11,520	0.7561	8,710
4	230,400	46,080	9,216	0.6575	6,060
5	184,320	36,864	7,373	0.5718	4,216
6	147,456	29,491	5,898	0.4972	2,933
7	117,965	23,593	4,719	0.4323	2,040
8	94,372	18,874	3,775	0.3759	1,419
		374,502	74,901		56,400

Table 3: Net present value of cash outflow (as revealed by table 1 and 2)

Equals	Present value of cash outflow on account of payment of installment	346,950
Less	Present value of cash savings on depreciation	56,400
	Net present value of cash outflow	290,550

Table-4: Present value of cash outflow on account of payment of hire charges

Date of payment	Hire charges	Discounted factor at 15%	Discount ed value	Present value of tax savings on hire charges	Net present value of cash outflow on hire charges
July 1, 2004	70,000	1.0000	70,000	14,000	56,000
July 1, 2005	70,000	0.8696	60,872	12,175	48,697

July 1, 2006	70,000	0.7561	52,927	10,585	42,342
July 1, 2007	70,000	0.6575	46,025	9,205	36,820
July 1, 2008	70,000	0.5718	40,026	8,005	32,021
July 1, 2009	70,000	0.4972	34,804	6,961	27,843
July 1, 2010	70,000	0.4323	30,261	6,052	24,209
July 1, 2011	70,000	0.3759	26,313	5,263	21,050
	560,000		361,228	72,246	288,982

As depicted on the above tables the NPV of cash outflow of Rs. 290,550 is in the case of purchase of machine on installment and the NPV on the payment of hire charges is only Rs. 288,982. Thus, it is beneficial to take the machine on hire rather than its purchase on installment. Since, there is a saving of Rs. 1,568 in NPV.

REVIEW QUESTIONS AND CASES

1. What is outright purchase? Explain with examples.
2. A Private Limited Special Industry is negotiating to purchase a machine with a Japanese manufacturer. Manufacturer has provided two options: outright purchase and hire charge. The terms of sale offered by the manufacturer is total cost of Rs. 390,000. If the industry decides to outright purchase it needs bank loan. The interest rate of bank loan is 10% on unpaid balance per installment each year for 5 years. The loan must be taken on July 17 2006. If the factory decides to take the machine on hire, it has to pay annual rent amounting Rs. 70,000 each year on July 17, beginning from 2006 the factory purchases to use the machine for 8 years from 2006.

The following additional information is also available:

1. Income tax is payable at a proportional rate 20 percent for a special industries.
2. The factory has adopted method of depreciation as prescribed by tax law.
3. Being an industry, the factory is entitled to depreciation allowance for additional 1/3 of the 15 percent normal rate per annum.
4. The machine is being purchased in the course of replacement of existing machine and no increase in the existing installed capacity is involved.
5. Assume that the cost of capital of 15 percent. The machine is not expected to get any salvage value at the end of 8^{th} year.

21.6.6 Timing Activities Planning

In ordinary sense, timing is an ability to choose or the choice of the best moment to do something. In taxation, timing of activities refers to the planning of schedule for business activities in such a way that minimizes tax liabilities. In other words, timing activities is the planning of future business activities in order to get benefit from tax by manipulating time facilitated by the law.

The analysis of timing activities helps to determine the scheduling or planning periods, how and when is the right time to make payment. The timing activities have to consider the need to comply with other regulatory requirements to which business is subject. Most planning strategies involve questioning when to complete transactions that affect taxes. Planning strategy is often built on two basic timing precepts:

1. Payment of tax owed on income transactions should be postponed as long as possible (provided no penalty is incurred).
2. Year-to-year tax bracket changes should be considered when making decisions to pay deductible expenses or receive taxable income.
3. By planning ahead, it can adjust withholding and estimated tax payments to help eliminate or reduce tax penalties. Making adjustments may also help to postpone payment of tax or let it shift some income or deductions to different tax years to at least lower taxes.
4. If anybody have a casualty loss (e.g., a loss due to fire, theft, or natural disaster), shifting income from one year to another may allow a greater loss deduction. In some cases, it can even choose in which year to claim the loss.
5. Tax planning helps to evaluate whether a deduction will really benefit. This strategy often is a good one; but under certain circumstances, it gains nothing, tax wise.

CASES AND SOLUTIONS

1. After suffering a loss for the past few years, a Ltd. Company expects the following operating results for next three years. Expected profits were Rs. 200,000 in year 1, Rs. 400,000 in year 2 and Rs. 600,000 in year 3.

In the backdrop of the above expected financial performance, the company would like to undertake the following activities within the

given period of three years. The company seeks your advice to consider the effect of tax planning to reduce the tax burden. The activities were:

1. To set off the preliminary expenses of ending year Rs. 250,000.
2. To install a pollution control (PC) device at a cost of Rs. 400,000.
3. To construct office building at a cost of Rs. 500,000.

Required:

(a) Timing of activities
(b) Effects of tax in planning these activities

Solution:

Activities planning statement

Particulars\Years	1	2	3	Total
Expected profit (loss)	200,000	400,000	600,000	1,200,000
Depreciation of office building	(25,000)	(23,750)	(22,563)	(71,313)
Set of preliminary expenses	(250,000)	-	-	(250,000)
PC costs	-	(188,125)	(211,875)	(400,000)
Loss during the year	75,000			75,000
Recovery of loss (from year 1)	-	(75,000)	-	(75,000)
Taxable income/(loss)	-	113,125	365,563	478,688
Tax rate		25	25	25
Tax liabilities	-	28,281	91,391	119,672

Clarification:

1. Maximization of cost is main aim in this problem. Thus, it is necessary to adopt the idea of cost maximization.
2. Set off preliminary expenses of ending year has to place in the first year and loss recovery made in the second year.
3. PC device at cost of Rs. 400,000 is to purchase on the installment basis considering its cost deduction for upper limit. Otherwise, the large amount of profit maximizes tax liabilities.
4. It is marvelous idea to incurred PC costs into two income years for considering its principles of not more than 50 percent of the adjusted taxable income.

2. A special industry expects the following operating results for the next three years.

1. Expected profits: Rs. 300,000 in year 1, Rs. 800,000 in year 2 and Rs. 500,000 in year 3.
2. Past years unrelieved losses: Rs. 800,000 past 2 years, Rs. 300,000 past 1 year and Rs. 100,000 previous year.
3. The company wants to undertake the following activities based on the above expected profits within the time limit of three years.
   (a) To install a pollution control device at a cost of Rs. 300,000.

(b) To take life insurance policy of the staff with annual premium of Rs. 50,000.

Required:

(a) Timing of activities.

(b) Effect of tax in planning these activities. [4+2]

Solution:

Activities planning statement

Particulars\Years	1	2	3	Total
Expected profit (loss)	300,000	800,000	500,000	1,600,000
Payment of LIP of staffs	(50,000)	(50,000)	(50,000)	(150,000)
PC costs	-	-	(225,000)	(225,000)
Recovery of loss (past 2 year)	(250,000)	(550,000)	-	(800,000)
Recovery of loss (past 1 year)	-	(200,000)	(100,000)	(300,000)
Recovery of loss-previous year	-	-	(100,000)	(100,000)
Taxable income/ (loss)	×	×	25,000	25,000
Tax rate	×	×	20	20
Tax liabilities	×	×	5,000	5,000

Clarification:

1. Life insurance policy of the staff with annual premium of Rs. 50,000 is spent to use from year 1.
2. The loss deducted as:
   (a) Loss of Rs. 800,000 of past 2 year deducted Rs. 250,000 and 550,000 in year 1 and 2 respectively.
   (b) In year 2 loss of past year 1 Rs. 200,000.
   (c) In year 3, all remaining loss deducted from the profit.
3. PC cost for device spent in year third for maximum deduction.

REVIEW QUESTIONS AND CASES

1. A special industry, Limited. Company has been taking into consideration to develop a long-term planning for its various capital assets policy. The Company would like to account cause and effect of tax policy on these activities. Past experience, shows that tax policy have not seen major departure. Therefore, the present policy will continue for the period it would like to consider.

The activities planned are being:

1. To invest in a new product research programs a sum of Rs. 500,000.
2. To buy a new plant at a cost of Rs. 500,000 for which it can expect an investment allowance of 15% on depreciable assets.

3. To issue 10,000 bonus shares of Rs. 10 each to the ordinary shareholders.
4. To sell an old plant at a profit of Rs. 150,000 and the balancing charge on which would be Rs. 700,000.
5. To redeem 1,200 debenture of Rs. 100 each at a discount of 10% and to credit the amount of discount to the profit and loss account in the year in which it would be redeemed.

The company expects the following profit (net income) for planned period:

1. Year I A profit of Rs. 250,000
2. Year 2 A loss of Rs. 90,000 before considering the depreciation of Rs. 80,000
3. Year 3 A profit of Rs. 250,000 including income from investment of Rs. 50,000
4. Year 4 A profit of Rs. 200,000
5. Year 5 A profit of Rs. 150,000

The average tax rate applicable to the company being 20%

Required:

(a) Timing of activities

(b) Total tax payable by the company each year after considering the consequences of various activities planned.

2. A Ltd; company has been considering to develop a long-term planning for its various capital assets policy. The company would like to account of cause and effect of tax policy on these activities. Past experience shows that the tax policy has not seen major departure, therefore, the present policy will continue for the period it would like to consider.

The activities planned are being

1. To buy a new plant at a cost of Rs. 400,000 for which it can except an investment allowance of 20% on depreciable assets.
2. To buy a new plant at a cost of Rs. 400,000 for which it can expect an investment allowance of 20% on depreciable assets.
3. To issue 10,000 Bonus shares of Rs.10 each to the ordinary share holders.
4. To sell an old plant at a profit of Rs. 100,000 and balancing a charge on which would be Rs. 700,000.
5. To redeem 1,000 debenture of Rs.100 each at a discount of 10% and to credit the amount of discount to the profit & loss account in the year in which it would be redeemed.

The company expects the following profits (net income) for planned period:

1. Year 1 A profit of Rs. 150,000
2. Year 2 A loss of Rs. 50,000 before considering the depreciation of Rs. 100,000
3. Year 3 A profit of Rs. 200,000 including income from investment of Rs. 50,000
4. Year 4 A profit of Rs. 150,000
5. Year 5 A profit of Rs. 200,000

The average tax rate applicable to the company being 50%

Required:

(a) Timing of activities

(b) Total tax payable by the company each year after considering the consequences of various activities planned.

(c) Timing of capital investment by considering comprehensive tax planning will reduce tax burden. Justify this statement briefly.

[MBA, 2051, TU, modified]

4. S Ltd Company expects the consequent operating results for the first 5 years as given below and a constant growth of 20% on its operating profit in the following years:

1. Loss of Rs. 40,000 in year one and year two
2. Profit of Rs. 50,000; Rs. 80,000; and Rs. 150,000 for year three, year four and years respectively. In the light of these expected financial performances it would like to consider the effect of tax planning to reduce tax burden. The company would like to undertake the following activities:
3. Issue of 10% Redeemable debenture of Rs. 1,000,000.
4. Use of pollution control devices at a cost of Rs. 200,000.
5. Purchase of capital assets at a cost of Rs. 150,000 to increase capacity by 30%.
6. Pay interim dividend of Rs. 50,000.
7. Sell capital assets at a loss of Rs. 30,000.

Required:

a) Timing of activities.

b) Amount of tax payable for 1st 5 years because of the consideration of activities planned. [MBA, 2052, TU, modified]

5. A Ltd. Company expects the following operating results for the first 5 years of commencement:

1. A loss of Rs. 10,000 in year 1 and Rs. 5,000 in year 2.

2. A profit of Rs. 25,000, Rs. 75,000, and Rs. 200,000 for third, fourth and fifth years respectively.

In the light of above expected financial performance the company likes to know the effect of tax planning to reduce the tax liabilities in connection to the following activities:

1. To run a 5 bed hospital purely for its employees at a cost of Rs. 75,000.
2. To install a capital asset at a cost of Rs. 30,000 that increases its capacity by 27%.
3. To install pollution control device at a cost of Rs. 100,000.
4. To pay a cash dividend of Rs. 50,000.

Required:

(a) Timing of activities

(b) Amount of tax at source payable for 1-5 years considering the activities planned. [5+5]

[MBA, 2053, TU, modified]

6. A Ltd, company would like to consider the effects of tax planning on the long-term capital assets planning policy. The government tax policies have not seen major departure in the past and the present policy would continue for the period of another 5 to 10 years. Planned activities:

1. To sell an assets costing Rs. 150,000 with an accumulated depreciation of Rs. 90,000 in Rs. 130,000.
2. To increase capacity of the machine by 40% at a cost of Rs. 240,000.
3. To use some pollution control devices at a cost of Rs. 400,000.
4. To purchase own debenture in the open market at a Rs. 80 each for debenture of Rs.100 each, and utilize the profit to write-off revenue losses.
5. To make new investment of Rs. 250,000 and to avail investment allowance of 30%.

The company expects the following results of operations before considering the above given activities for the period it would like to consider

Year I	Loss of Rs. 60,000
Year II	Loss of Rs. 150,000
Year III	Profit of Rs. 90,000
Year IV	Profit Rs. 150,000
Year V	Profit of Rs. 250,000

Required:

(a) Timing of activities.

(b) Amount of tax payable in each year after considering the consequences of activities planned. [10]

(c) Proper tax planning can shift the burden of tax to the subsequent assessment years. Justify this statement with example where necessary. [10] [MBA, 2054, TU, modified]

7. A company has been considering developing a long-term planning for various activities. It would like to take into account of effect of tax on these activities. The experience in the past have shown that the tax policy have been more or less stable and have not shown a drastic changes in the past, therefore the present policy would continue for the period the company has been considering. Activities planned being:

1. To purchase some fixed assets worth of Rs. 500,000 and for which the company expects an investment allowance of 40% on depreciable assets.
2. To redeem 8% debentures of Rs. 200,000 at a premium of 20%, and to write off the premium paid in the year in which it would be redeemed.
3. To sell an old lorry at a terminal depreciation of Rs. 40,000 the book value of which is Rs. 100,000?
4. To retrench some employee with severance pay of Rs. 100,000. In this process the company has also prepared its forecaste not total income for coming 5 years before considering the consequences of above mentioned activities.

Year I	A net loss of Rs. 200,000 after charging depreciation of Rs. 80,000.
Year II	A profit of Rs. 150,000 including profit from other sources of Rs.80000.
Year III	A profit of Rs. 300,000.
Year IV	A profit of Rs. 200,000 before considering the profit of Rs. 50,000 from the sale of assets.
Year V	A profit of Rs. 200,000.

The average tax rate applicable to the company would be 40%.

Required:

As a tax expert your opinion about the timing of these activities, and a detailed wording of consequences and the effect of tax planning activities [10]

[MBA, 2055, TU, modified]

8. The following are the anticipated profit of a Limited Company, established in one of the least developed area for the first seven succeeding years.

Year	1	2	3	4	5	6	7
Profit(loss)	255,000	100,000	90,000	150,000	200,000	250,000	200,000

The company likes to perform the following financial activities during these periods. It is expected that there would not be major departure in the government policy for another few years.

1. To pay a cash dividend of Rs. 50,000.
2. To donate Rs. 100,000 to Pashupati Development Trust.
3. To install a machine at a cost of Rs. 300,000 and that would increase the production capacity by 35%
4. To open a hospital at a cost of Rs. 200,000 inside the company's premises purely for its employees.

In the light of above financial performance, the company likes to know the effect of tax planning to reduce the tax liabilities for the above periods. [10]

Required:

(a) Timing of activities

(b) Amount of tax payable from 1 to 7 years [3+3]

9. The following are the anticipated profit of Limited Company established in one of the undeveloped area for the first seven succeeding years.

Year	1	2	3	4	5	6	7
P/L	30,000	60,000	50,000	100,000	200,000	150,000	100,000

The company likes to undertake the following financial activities during these periods. It is expected that there would not be major departure in the government policy for another few years.

Activities:

1. To Pay Rs. 25,000 each to three major political Parties.
2. To donate Rs. 15,000 to public school in the second year of operation and Rs. 50,000 to Lumbini Development Trust
3. To install a machine at a cost of Rs. 200,000 and that would increase the production capacity by 26%
4. To install a pollution control device at cost of Rs. 100000
5. To sale an old plant for Rs. 10000 [Model, MBS, 2057, TU, modified

10. After suffering losses over losses for several years, a Ltd. Company expects the following operating results for the next three years.

Expected Profit:	Year	1	2	3
		Rs. 300,000	400,000	500,000
Past Losses:	Year	1	2	3
		Rs. 300,000	400,000	500,000

In the light of these expected financial performances the company would like to undertake the following activities within these three years and seeks your advice to consider the effect of tax planning to reduce the tax burden. The activities are:

1. To launch a Family Planning Program at a cost of Rs. 150,000 for the company's employees. It is expected that 2/3rd cost is used on purchase of planning instrument and rest for the other expenses.
2. To install a machine at a cost of Rs. 500,000. After installation it is expected that the production would increase by 30%.
3. To redeem bank loan of Rs. 200,000.

Required:

(a) Timing of activities.

(b) Effect of tax planning activities. [6]

[MBS, 2058, TU, modified]

11. After incurring losses for the past two years. A Ltd. company anticipates the following operating results in the next three years.]

Year 1 and year 2 Year 3, 4 and 5	Rs.75,000 Rs.100,000 And Rs.250,000	Rs.50,000 Rs.20,000 respectively

In the light of these expected financial performances, the company would like to undertake the following activities and seeks your advice to consider the effect of tax planning to reduce tax liability. The activities anticipated are:

1. To write off preliminary expenses of Rs. 50,000 in year 3, 4 & 5.
2. To install a pollution control device at a cost of Rs. 150,000.
3. To launch a Life Insurance scheme for company's employees. The total yearly premium being Rs. 50,000.

Required:

(a) Timing activities

(b) Amount of tax payable for the last 5 years considering the activities planned above. [3+3]

[MBS, 2059, TU, modified

12. After suffering a loss for the past few years; a Ltd. Company expects the following operating results for the next three years.

Expected profits: Rs.200000 in year 1, Rs.400000 in year 2 and Rs.600000 in year 3.

Past losses were: Rs.400000 in year 1, Rs.200000 in year 2 and Rs.50000 in year 3.

In the backdrop of the above expected financial performance the company would like to undertake the following activities within the given period of three years. The company seeks your advice to consider the effect of tax planning to reduce the tax burden. The activities were:

1. To set off the preliminary expenses of Rs. 250,000.
2. To install a pollution control device at a cost of Rs. 400,000.
3. To construct office building at a cost of Rs. 500,000.

Required:

(a) Timing of Activities.

(b) Effect of tax in planning these activities. [3+3]

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Appendices

Appendix - I

SYLLABUSES

Master of Business Studies (MBS), TU.

Course title: Tax Laws and Tax Planning
Course: ACC612 Full Marks: 100
Nature of the course: Specialization Pass Marks: 40
Duration of the course: 100 lecture hours Duration
of the class: 60 minutes

Course Objectives

This course aims to provide to students with the knowledge of tax laws and tax planning for decisions making and enable them to work as tax consultants in the corporate sector.

Course description

This course includes various modes of computing net incomes and tax liabilities of business houses in Nepal. It also includes the value added tax concept and mode of computing it. The courses further deals on the concept of tax planning and its effect in investment and depreciation policy in timing of various management options.

1. **Conceptual foundation**
   1.1 Concept of tax
   1.2 Historical development of tax laws in Nepal
   1.3 Definition of related terms
   1.4 Heads of income.

2. **Business taxation in Nepal**
   2.1 Computation of taxable income of company and non-company assessed including sole proprietorship, private limited company, public limited company, corporations (companies quoted or not quoted in stock exchange) and professional.
   2.2 Income from investment.

3. **Setoff and carry forward of losses**
   3.1 Model of set off and carry forward of losses and accumulated losses, 3.2 Inter-source and inter-head adjustments.

4. **Procedure for assessment**
   4.1 Tax assessment order

4.2 Method of collection and realization
4.3 Types of assessment
4.4 Income tax authorities their powers and duties
4.5 Assessee and their duties and rights
4.6 Penalties for non-payment and non-submission
4.7 Appeal and revision, Appellate hierarchy
4.8 Process of appeal and revision and their procedures,
4.9 Refund of excess payment and tax certificate.

5. Value added tax (VAT)
5.1 Concept of VAT
5.2 Origin and evolution of VAT
5.3 Principles governing VAT
5.4 VAT as a substitute of sales tax
5.5 Methods of computing VAT.

6. Tax planning
6.1 Concept of tax planning
6.2 Significance of tax planning
6.3 Tax evasion and tax planning
6.4 Tax avoidance and tax planning
6.5 Scope of tax planning
6.6 Basics of tax planning.

7. Exemptions and rebate
7.1 Technical collaborations foreign industries,
7.2 Foreign aided enterprises and tax rebates and exemption,
7.3 New industrial setup,
7.4 Capacity increase and their effect on tax planning,
7.5 Export promotion and tax planning,
7.6 Investment tax credit and its impact on tax planning.

8. Tax planning for various payments and activities
8.1 Remuneration payment
8.2 Self-employment,
8.3 Capital structure
8.4 Depreciation system
8.5 Location of industrial setup
8.6 Timing of activities.

Master of Public Administration (MPA), TU.

Course title: Tax Administration in Nepal
Course: PF 644 Full Marks: 50
Nature of the course: Specialization Pass Marks: 20
Duration of the course: 50 lecture hours (Duration of the class: 60 minutes)

Course Objectives
The objective of the course is to acquaint the student with a comprehensive knowledge about the Tax Administration System in Nepal along with different aspects of Tax Administration and Tax Laws of Nepal.

Course Contents

1. Introduction **LH 8**

1.1 Definition and concept of taxation
1.2 Silent feature of taxation as mentioned in the Constitution of Nepal;
1.3 Historical development of taxation in Nepal.

2. Sources and structure of taxation in Nepal **LH 12**

2.1 Value added tax
2.2 Customs
2.3 Income tax
  2.3.1.1 Personal income tax
  2.3.1.2 Corporate tax
  2.3.1.3 Employment tax
2.4 Urban House and Land tax
2.5 Registration fee
2.6 House rent tax
2.7 Other taxes.

3. Tax assessment and collection **LH 12**

3.1 Method of income tax assessment
  (a) Income assessment
    3.1.1 Summary assessment
    3.1.2 Best judgment based assessment
    3.1.3 Assessment based on book of accounts
    3.1.4 Self assessment
  (b) Income tax assessment
3.2 Assessment of Urban House and Land Tax
3.3 Assessment of VAT
3.4 Assessment of remuneration tax

3.5 House rent tax
3.6 Assessment of other taxes
3.7 Tax collection procedures.

4. Income Tax Administration **LH 12**

4.1 Tax authorities: Ministry, Department and field offices
4.2 Rights and duties of tax officer and taxpayer
4.3 Administrative procedure for paying tax
4.4 Role of investigation: monitoring and tax audit
4.5 Training and development of tax personnel
4.6 Problems of tax administration and their remedies.

5. Income Tax Laws **LH 6**

5.1 Legal provisions
5.2 Fine and Penalty of defaulters
5.3 Methods of appealing in the Court.

Appendix - II
FINAL EXAMINATION
Master of Business Studies (MBS), TU
2060

M.B.S. / II year/Management — Full Marks: 80
Tax Laws and Tax Planning (Acc. 613) — Time: 4 hours

Candidates are required to give their answers in their own words as far as practicable.
The figures in the margin indicate full marks.

Group 'A'

Attempt all the questions.

1. Income Tax Act, 2058 has invited the potential investors to promote industries in undeveloped areas." Show your acquaintance with the various provisions that are given in the above act to promote industries. [6]
2. Concealing the income by an assessee is one of the possible defects of the self assessment tax system." Comment. [6]

   Or

   A firm can manage its tax-flows with the help of Timing of Activities scheme. Comment. [6]
3. Inclusions of Value Added Tax in the price of commodity in contrary to the basic philosophy of the Value Added Tax." Give your opinion in favor of above statement. [6]

   Or

   An importer imported a VCR from Japan. No VAT was paid on it. This item passes to the consumer through two middlemen, i.e., wholesaler and retailer. The consumer paid Rs. 20,215 net for this item. Both the middlemen charged 7% profit on their cost price.

   Required:
   (a) Cost price to importer
   (b) Value Added Tax at each level of sales [3+3]

4. A Ltd. Company wants to invest in a capital outlay of Rs. 1,000,000 in a Juice Factory. However considering the facilities extended by Income Tax Act, 2058 localization in other part also cannot be ignored. Company has considered Sindhuli and Kalaiya sas other two alternative locations.
   The Income Tax Act 2058 has provided the following concessions for location at different places.

No rebate will be allowed if factory is located at Kathmandu. 20% rebate will be extended, if it is located at any part of Terai Region, and 80% rebate for 1st 2 years and 20% concession for another 3 years if located at hilly regions. Kathmandu is the major market for this product and hilly regions are the major suppliers of inputs. The anticipated production and sale of the factory will be 10,000 bottles of finished goods of 1 litre each 10 Kgs for input will be required to produce one bottle of finished product. Assume the factory runs throughout the year with targeted capacity. Consider the following further information.

Alternate 1: If the factory is located at Kathmandu

- 80% of inputs will be supplied from hilly regions and balance 20% will be available locally.
- Road will be means of transport.
- Average transportation cost per 10 Kgs of input is Rs. 4.

Alternate 2: If the factory is located at Kalaiya

- 60% oe inputs will be supplied from hilly regions and balance 40% will be available locally.
- Road will be the means of transport.
- Transportation cost of finished product to Kathmandu by road will be Rs. 2 per bottle.

Alternate 3: If the factory is located at sindhuli

- Raw inputs will be available locally
- Road will be means of transport
- Transportation cost of finished product to Kathmandu by road will be Rs. 2 per bottle.

Required:

As a tax planner, which alternative is the best from the point view of tax? Charge depreciation at the rate of one percent per annum. [6]

5. After suffering a loss for the past few years, a Ltd. Company expects the following operating results for the next three years.
Expected profits: Rs. 200,000 in year 1, Rs. 400,000 in year 2 and Rs. 600,000 in year 3. Past losses were: Rs. 400,000 in year 1, Rs. 200,000 in year 2 and Rs. 50,000 in year 3. In the backdrop fo the above expected financial performance, the company would like to undertake the following activities within the given period of three years. The company seeks your advice to consider the effect of tax planning to reduce the tax burden. The activities were:

To set off the preliminary expenses of Rs. 250,000. To install a pollution control device at a cost of Rs. 400,000. To construct office building at a cost of Rs. 500,000.

Required:

(a) Timing of activities

(b) Affects of tax in planning these activities [6]

6. The given is the summarized statement of cash pertaining to an artist:

Statement of Cash

Receipts	Amount	Payments	Amount
To balance of cash	200,000	By car purchased	400,000
To receipt from script playing	400,000	By car expenses	100,000
To receipt from dance training		By salary to assistants	150,000
Program	100,000	By life insurance premium	8,000
To advisory fees	100,000	By donation to a local club	50,000
		By balance of cash	92,000
	800,000		800,000

Further information:

75% of car expenses were related to her professional job. A policy of Rs. 100,000 was taken on her own life. A compensation of Rs. 200,000 for the breach of contract from a producer has not been received yet. She incurred Rs. 30,000 as legal expenses to recover this amount.

Required:

(a) Income from profession (assessable income).

(b) Statement of total income (taxable income) [4+2]

7. The Balance Sheet of a Limited Company of the previous year showed a depreciated value of its asset grouped under D Rs. 650,000 during this year the company added two items of this group: one of Rs. 100,000 on Kartik 1, and another of Rs. 150,000 on 1st Baisakh. However, the company disposed off one of its asset with book value on opening date of Rs. 50,000 and original value of Rs. 75,000 at Rs. 80,000.

Required:

(a) Depreciated value of assets at closing

(b) Current amount of depreciation

(c) Capital gain on the deal [6]

8. The following is the receipts and payments account of Housing Company for the previous year:

Receipts	Amounts	Payments	Amounts
To opening balance	450,000	By purchase of house	1,000,000
To Rent collection	1,000,000	By office expenses	80,000

To commission received on house rent	50,000	By staff salary	200,000
To sale of house	1,500,000	By cash dividend	100,000
To loan to purchase	1,000,000	By interest on loan to house purchase	20,000
		By payment of partial loan	800,000
		By legal expenses	10,000
		By donation	20,000
		By miscellaneous expenses	50,000
		By balance c/d	1,720,000
	4,000,000		4,000,000

Further information:

50% of legal expenses were related to loan taken and balance for registration on the purchase of house sold. Assessee could not produce the evidence for 5% of the donation paid. Miscellaneous expenses include Rs. 20,000 paid for the accident insurance of shareholders. Rs. 10,000 for life insurance premium of staff member and balance Rs. 20,000 was paid to an unregistered loan taken from a private money lender. Total depreciation allowed for the houses was Rs. 30,000.

Required:

(a) Assessable income from house and land rent

(b) Tax liability [4+2=6]

GROUP B

Attempt any TWO questions.

9. Lack of clarity in the Income Tax Act, 2058 has completely failed to address the expectation of Nepalese taxpayer. Comment. [16]

10. (a) A successful tax planner should employ its expenditure scheme in such a way that both the employer and employee would be benefited. Justify this statement in the light of salaried person citing at least two examples. [8]

(b) A company estimated a capital outlay of Rs. 1,000,000 for its expansion program. Company's adviser has suggested the following four alternatives.

	Alternate 1	Alternate 2	Alternate 3	Alternate 4
Share capital Rs.	1,000,000	500,000	400,000	-
7% Debenture	-	500,000	400,000	-
15% term loan	-	-	200,000	500,000
24% Private loan	-	-	-	500,000
Total	1,000,000	1,000,000	1,000,000	100,000

The company expects a net income of Rs. 4,000; before charging interest and the cost of financing expenses scheme, a day from this expansion program from the date of its commercial operation. The dealer agreed to extend 60 days credit supply the machine subject to payment is made within the credit period. At present the company is incurring a loss of Rs. 1,000 a day.

Experience shows that it takes normally one and half months to obtain fund either from issuing shares of debentures, whereas it takes 15 days and 5 days to avail funds from bank or private money lenders respectively. Extension works would be completed within 15 days for its commercial production. Loan will be retired on the very day of operation. Company incurred 2% scheme expenses (assume revenue) to raise fund from share and debenture. The corporate tax rate is 20%. Assume 360 days a year.

Required:

Which alternative is preferable and why? [8]

11. The following are the details of the transaction of and Industrial Company for the relevant financial year.

Income Statement

Particulars	Amounts	Particulars	Amounts
To opening stock	700,000	By sales	13,500,000
To purchase	5,300,000	By sale of scraps	25,000
To freight	345,000	By commission	50,000
To wages	2,500,000	By dividends	60,000
To royalty	500,000	By house rent	300,000
To R&I costs	100,000	By profit on sale of	
To salaries	300,000	land	500,000
To general charges	600,000	By interest	75,000
To legal expenses	80,000	By bad debts	
To provision for tax	50,000	recovered	65,000
To R&D costs	150,000	By closing stock	500,000
To bad debts	200,000		
To depreciation	700,000		
To entertainment	160,000		
To dividends	80,000		
To advertisement	250,000		
To donation	400,000		
To reserve for B/D	150,000		
To net profit	2,510,000		
	1,5075000		15,075,000

Additional information:

Bad debts recovered upto Rs. 4,000 was not allowed previously. Donation includes Rs. 10,000 given to a public hospital. Legal expenses include Rs. 15,000 paid to lawyer for briefing income tax rules to the finance director. Amount allowed by ITA for depreciation was Rs. 650,000 purchase includes Rs. 150,000 being cost of new computer. General charges include Rs. 80,000 pollution control expenses and Rs. 25,000 for income tax appeal. Income tax paid Rs. 60,000 and the custom duty Rs. 200,000 are not shown in above statement. Both of the stocks are overvalued by 10%.

Required:

(a) statement of Total Taxable Income

(b) Tax liabilities [14+2]

FINAL EXAMINATION 2061

M.B.S. / II year / Management — Full Marks: 80

Tax Laws and Tax Planning (Acc. 613) — Time: 4 hours

Candidates are required to give their answers in their own words as far as practicable.

The figures in the margin indicate full marks.

Group 'A'

Attempt all the questions.

1. "The present tax policy of the government is enough for the overall development of the industries in under developed areas". Comment in brief the above statement on the basis of IT Act 2058. [6]

2. "Inclusion of self assessment provision in tax law could be the most effective tax policy, provided that the taxpayer cooperates with it fully." Comment. [6]

3. 'There is a gradual increase in the tax revenue since the implementation of vat'. Give two reasons how vat has helped increases tax revenue of Nepal. [6]

Or

A consumer purchased a Micro-Oven from a retailer paying Rs. 22,000 inclusive VAT. Two middlemen i.e. wholesaler and retailer were involved in this deal. Both of them charged a profit margin of 7% and 10% respectively on their cost price. The importer had not paid VAT on its import.

Required:

(a) Cost price importer

(b) Vat collected by the government at each level of sales. [6]

4. A co. ltd. wants to invest a total capital of Rs. 1000000 in a shoe factory. The company expects the following profits before depreciation, transportation, cost and tax.

Year	1	2	3	4	5
Profit	150,000	200,000	300,000	400,000	300,000

The company has considered Kathmandu, Dharan, and Dailekh, the three alternative locations, to install the factory.

Consider the following concession and rebate as provided by ITA before installment of the machine.

- ♦ No rebate will be allowed if factory is located in Kathmandu
- ♦ 10% rebate on tax will be allowed if it is located at any part of Terai and
- ♦ 60% rebate for the first two years and 10% rebates for another 2 years, if it is located at hilly region.

Kathmandu is the major market of this product and hilly regions are major suppliers of raw inputs. Company's expected production and sales is 50,000 pairs of different sizes of shoes. On an average two square feet of leather is required to make a pair of shoe irrespective of size. Assume that the company achieved both production and sales target and there is no stock at the end.

Further information:

Alternative No 1: If factory is located in Kathmandu.

- ♦ All inputs will be supplied from hilly regions.
- ♦ Road will be the means of transport.
- ♦ Average transportation cost per 10 square feet if leather is Rs. 5.00.

Alternative No. 2: If factory is located at Dharan.

- ♦ 80% inputs will be supplied from hilly regions and the balance 20% is available locally.
- ♦ Road will be the means of transport.
- ♦ Average transportation cost per 10 sq. ft. of leather is Rs. 2.00.
- ♦ Transportation cost of finished product to Kathmandu will be Rs. 0.50 per pair.

Alternative No. 3: If factory is located in Dailekh.

- ♦ 80% raw inputs will be available locally and the balance 20% will be supplied from Terai.

- Road will be the means of transport.
- Average cost of input collection from the surrounding collection centre is Rs. 1 per 10 sq. ft.
- Transportation cost of finished product to Kathmandu by road will be Rs. 1 per pair.

Required:

As a tax planner which alternative is the best from the point of view of tax? Charge 15% p.a. depreciation on plant. Assume the corporate tax rate is 20%. [6]

5. A Ltd. Company expects the following operating results in the next three year.

Expected profit: Rs. 500,000 in year 1, Rs. 600,000 in year 2 and Rs. 400,000 in year 3. Past loss suffered: Rs. 800,000 in year 1, Rs. 300,000 in year 2 and Rs. 100,000 in year 3.

The company wants to undertake the following activities based on the above-expected profits within the limits of three years.

- To install a pollution control device at a cost of Rs. 300,000.
- To take a life insurance Policy of the staff with annual premium of Rs. 50,000.

Required:

(a) Timing the activities.

(b) Effect of tax planning these activities. [6]

6. Following is the summarized statement of cash concerning an actor for the previous year.

Statement of cash

Receipts	Amounts	Payments	Amounts
To balance of cash	450,000	By purchase of car	300,000
To advance receipt for signing script playing	300,000	By car expenses	75,000
To receipt from script playing	600,000	By life insurance premium	10,000
To rent from house let out	150,000	By salary to personal assistant	102,000
		By donation to Myaglung Bazar	1,000
		By balance of cash	1,003,000
	1,500,000		1,500,000

Additional information:

1. Car was purchased on Paush of the previous year. It was used equally for both professional and personal work.
2. Dashain bonus to the assistant equal to one month salary has both been paid yet.

Required:

(a) Income from profession

(b) Statement of total income [4+2]

7. As shown by the balance sheet of a Ltd. Company in the previous year, the depreciated value of its assets grouped under C was Rs. 1,500,000 during this year, the company added two more assets of this group: one on Bhadra of Rs. 500,000 and another on Falgun of Rs. 600,000 the company disposed off one asset with book value on opening date of Rs. 100,000 at Rs. 125,000.

Required

(a) Current amount of depreciation to be charged

(b) Depreciation base of asset at closing [4+2]

8. The following receipts and payments account of Mr. A for the previous year.

Statement of Cash

Receipts	Amount	Payments	Amounts
To opening cash balance	200,000	By collection cost of interest	3,000
To interest on private money lending activities	150,000	By taxi charge	200
To royalty from natural resources after TDS	170,000	By rent of room used for office	36,000
To interest on fixed deposit after TDS	9,400	By salary to assistant	120,000
		By donation to different exempt organizations	15,000
To royalty from books	30,000	By balance of cash	430,200
To amount receiving in lieu of accepting restriction on investment	50,000		
	609,400		609,400

Additional information:

1. Collection cost interest relates to money lending activities.
2. Taxi was used to collect interest on fixed deposit.
3. Legal expenses relates to preparing legal documents concerning to investment restriction.
4. Evidence against donation of Rs. 2,000 paid, could not be produced.

Required

(a) Net (Assessable) income from investment.

(b) Statement of total assessable income [4+2]

GROUP "B"

9. Income tax act, 2058 has given a lot of discretionary powers to Tax officer. Show your acquaintance with relevant provisions of the act. Also suggest some effective measures how this power exercise should be minimized. [16]

10. (a) How does the timing of activities help to reduce the tax liability and cash flows? Explain. [8]

A company has the following four alternatives capital structure to avail funds for its expansion program

Particulars	Alternate 1	Alternate 2	Alternate 3	Alternate 4
Equity Rs.	100,000	600,000	-	-
8% debenture	-	400,000	500,000	-
12% bank loan	-	-	500,000	600,000
20% private loan	-	-	-	400,000
Total fund	1,000,000	1,000,000	1,000,000	1,000,000

The company has expected a profit of Rs. 600 per day before charging interest and depreciation from the present scheme. At present the firm is bearing a loss of Rs. 2000 per say. The new asset falls under group D. profit could be reaped from the day of its commercial operation.

The dealer has agreed to supply the plant on 60 days credit subject to payment is made within credit period. Installation work could be completed within 30 days for its commercial operation. Assume that the supplier is paid within the credit period.

The Accounts department informed that it takes normally one and a half months to avail fund either by issuing share or debenture whereas it takes 15 days and 7 days only to obtain fund from bank and or private moneylenders respectively.
The corporate tax is 20%. Assume 360 days a year.

Required:

Suggest the management which alternative is the best one from the point of a tax planner. [8]

11. The trading and Profit and Loss account of a Ltd. Company for the previous year is given below:

Particulars	Amounts	Particulars	Amounts
To opening stock	500,000	By sales	4,000,000
To purchase	1,000,000	By commission	
To freight	30,000	earned	100,000
To wages	420,000	By rent from staff	

To salaries	600,000	quarter	350,000
To entertainment	150,000	By gain on sale of a	
To donation	300,000	machine	135,000
To depreciation	250,000	By interest charged	
To advertisement	50,000	on credit sales	35,000
To bad debts	20,000	By bad debts	
To reserve for bad debts	60,000	recovered	50,000
To R&D costs	350,000	By closing stock	400,000
To general expenses	450,000		
To dividend	70,000		
To net profit	880,000		
	5,130,000		5,130,000

Additional information:

1. In the last stock taking, the closing stock was of Rs. 450,000;
2. Wages includes Rs. 50,000 paid on the construction of additional office building.
3. Out of total donation paid, Rs. 100,000 was paid to Lumbini Development trust, another Rs. 100,000 was paid to Pashupatinath development trust and balance Rs. 100,000 was paid to Maharsi Janak University.
4. Total depreciation allowed by IT office for the current year was Rs. 215,000.
5. Bad debts allowed by the law was Rs. 10,000.
6. General expenses include:
   - Rs. 300,000 for pollution control expenses and Rs. 100,000 for the purchase of new sofa set for office use.
   - 30% of the bad debts recovered were not allowed previously.
   - Entertainment expenses include Rs. 30,000 was paid for advance tax

Required:

(a) Net assessable income from taxation

(b) Statement of total income

(c) Tax liabilities. [12+2+2]

FINAL EXAMINATION
2062

M.B.S. / II year / Management | Full Marks: 80
Tax Laws and Tax Planning (Acc. 613) | Time: 4 hours

Candidates are required to give their answers in their own words as far as practicable.
The figures in the margin indicate full marks.

Group 'A'

Attempt all the questions.

1. Explain the term "withholding payment (tax deduction at source)." State those payments which shall be treated as final withholding (final deduction of tax at source) under Income Tax Act, 2058. [6]

2. "Self assessment is the best method ever exercised to collect tax if it is assessed rightly." Comment.

   Or

   'Through proper tax planning scheme assessee can reduce his tax liability.' Explain this statement in light of timing of activities. [6]

3. 'Effectiveness of Value Added Tax depends upon the tax consciousness of the people'. Discuss. [6]

   Or

   A dealer imported a refrigerator from India paying VAT to the government. The refrigerator passes to the consumer through two middlemen i.e., wholesaler and retailer. Each businessman incurred expenses of Rs. 1,000 before selling it to their customers at a profit of 15% on sales price. The final consumer paid Rs. 5,000 VAT on this item.

Required:

(a) Cost price of importer
(b) Amount of VAT at each level of sales [3+3]

4. The following are the anticipated profit of a limited company for the first six succeeding years.

Year	1	2	3	4	5	6
Profit/loss	(100,000)	50,000	(50,000)	100,000	200,000	400,000

The company likes to undertake the following financial activities during this period. It is expected that there would not be major departure in the government policy for another few years. The company seeks your advice to consider the effect of tax planning to reduce the tax burden. The activities were:

1. To have research and development expenses of Rs. 80,000.
2. To donate Rs. 15,000 to a tax exempt public school.
3. To redeem bank loan of Rs. 100,000.
4. To install a pollution control device at a cost of Rs. 75,000.
5. To buy a patent having life of three years at a cost of Rs. 75, 000.

Required:

(a) Timing of activities

(b) Among of tax payable in each year [5+1]

5. A Ltd Co. contemplates to invest a capital outlay of Rs. 3,000,000 in a carpet factory. The company expects the following profit before depreciation, transportation and income tax.

Year	1	2	3	4	5
Profit (Rs.)	400,000	550,000	600,000	750,000	800,000

Government does not prohibit locating factory anywhere however the Income Tax Act, 2058 has provided the following tax rebates for location at different regions:

a. No rebate if the factory is located at Kathmandu.
b. 20% rebate if it is established at underdeveloped region.
c. 25% rebate if it is established at undeveloped region.
d. 30% rebate if it is established at remote areas.

Kathmandu would be major market of finished product whereas raw material of the product will be available locally everywhere. The company would like to fix single price for its product. The cost of transportation of finished product to Kathmandu would be Rs. 4,000; Rs. 6,000 and Rs. 6,500 per 500 square meter from underdeveloped area undeveloped area and remote area respectively. The budgeted production and sale of the company is 10,000 sq. meter per year i.e. 20 trucks of 500 sq. meter each. The company intends to invest 1/3 (one third) out of the total capital out lay in acquiring the required plant and machinery (under group – 'D' assets).

Required:

As a tax planner, where would you recommend to establish the factory and why? [6]

6. The balance sheet of a Ltd. Co. shows the following details of its assets under different pools.

Particulars	**Pool –'B'**	**Pool – 'D'**
Depreciation base at the beginning of the year	600,000	300,000
New additions of assets: On Poush 15	--	100,000

On Chaitra 15	300,000	--
Assets disposed off during the period: Book value at the beginning Disposed off value	 300,000 250,000	 300,000 398,000

Required:

(a) Current amount of depreciation to be charged.

(b) Opening depreciation base of the assets for the next year. [4+2]

7. The following is the summarized statement of cash concerning an auditor for the previous year.

Statement of cash

Particulars	Amount	Particulars	Amount
To balance of cash	175,000	By office expenses	140,000
To audit fees	250,000	By office rent	150,000
To consultation fees	100,000	By medical expenses (self)	5,000
To interest on personal loan	200,000	By life insurance premium	25,000
To rent from office computer	25,000	By donation	25,000
To income from writing articles	65,000	By purchase of computer	175,000
To income from dividend	210,000	By balance	505,000
	1,025,000		1,025,000

On query made by the tax officer, the following facts were revealed.

1. The insurance policy of Rs. 300,000 was taken on his own life.
2. The computer was purchased on Bhadra 1.
3. Depreciation base of the office furniture at the beginning of the year was Rs. 125,000.
4. Dividend was received from a domestic company.
5. During the year he has paid Rs. 10,000 income tax in advance.
6. His working place lies in a 'D' remote area and has selected individual status for income tax purpose.
7. Loss on profession Rs. 100,000 of the previous assessment year.

Required:

(a) Assessable income from profession.

(b) Statement of total taxable income

(c) Tax liability. [3+2+1]

8. Mr. Ale disclosed the following information during the previous income year.

1. Interest from private money transaction (gross) Rs. 50,000.
2. Income from royalty on books Rs. 85, 000 (net)
3. Income from natural resources Rs. 35,000
4. Gifts received in respect of private investment Rs. 10,000.
5. Rent from house Rs. 150,000.(net)

6. Rent from letting machinery Rs. 170,000 (net).

He claimed the following expenses:

1. Repair of rented machinery Rs. 40,000.
2. Expenses incurred for writing books Rs. 10,000.
3. Repair of rent houses Rs. 45,000.
4. Donation to tax exempt organization Rs. 10, 000.

It is noted that that beginning depreciation base of rented machinery was Rs. 500,000 at the beginning of the year.

Required:

(a) Net (assemble) income from investment

(b) Statement of total taxable Income [4+2]

GROUP "B"

Attempt any two questions.

9. 'Although the income tax Act, 2058 is far more superior to the previous income tax act, however, the law in itself would not be sufficient to increase tax revenue, the implementation of law should be effective.' Comment [16]

(a) Set off and carry forward of losses provide incentive and relief to the taxpayer.' Briefly describe how the treatment of business loss and investment loss differs. [8]

(b) A company requires Rs. 1,000,000 capital outlay for its expansion purpose. Company's advisor has suggested the following four alternatives.

Particulars	**Alternative 1**	**Alternative 2**	**Alternative3**	**Alternative 4**
Share capital	1,000,000	500,000	200,000	-
7% Debenture	-	500,000	500,000	-
18% Bank loan	-	-	300,000	500,000
20% Private loan	-	-	-	500,000
	1,000,000	1,000,000	1,000,000	1,000,000

After expansion, the company has expected a profit of Rs. 7,000 per day before flotation cost and brokerage charge. It takes only 20 days to complete extension work. The flotation cost is 2% for both new share and debenture. However, the company has to incur 1% as brokerage charge to obtain loan from bank. Normally it takes two and half months to avail capital by issuing new shares and one month by issuing debenture, loan from bank can be obtained from bank within 10 days, where as, it takes 4 days to obtain it from private lenders. At present the company is bearing a loss of Rs. 2,500 per day. The corporate tax rate is 20%. Assume 360 days in a year.

Required:

Suggest which alternative is preferable. [8]

10. The Trading and Profit & Loss Account of a Ltd., Company for the previous year is given below:

Income Statement

Particulars	Amount	Particulars	Amount
To Opening stock	150,000	By Sales	5,000,000
To Purchase	2,000,000	By Rent from staff quarter	60,000
To Freight	200,000	By Bad debts recovered	40,000
To Wages and salaries	1,000,000	By Commission	100,000
To Office Expenses	200,000	By Share transfer fees	10,000
To Interest on loan	80,000	By Sale of vacant land used	
To Annual renewals	10,000	in business	500,000
To Depreciation	200,000	By Sundry incomes	90,000
To Repairs	30,000		
To Advertisement	50,000		
To Reserve fund	70,000		
To Bad debts	75,000		
To Miscellaneous expenses	180,000		
To Net profit	1,555,000		
	5,800,000		5,800,000

Additional information:

1. Opening stock was over valued by Rs. 30,000.
2. Rs. 20,000 of bad debts recovered was not allowed to write off previously.
3. 1/3 of the bad debts shown were not acceptable.
4. Allowable depreciation on pool 'B' assets Rs. 50,000 is not included in the above statement.
5. Loan was taken to construct office building.
6. Repairs included Rs. 20,000 relating to Pool 'B' assets.
7. Office expenses included Rs. 60,000 cash payment made at a time even though banking service was available.
8. Miscellaneous expenses include;
7. Rs. 50,000 dividends paid to the shareholders.
8. Insurance premium for the office staff Rs. 50,000.
9. Income Tax paid in advance Rs. 20,000.
10. Donations to Lumbini Development Trust Rs. 30,000.
11. Sundry income include: (a) Refund of custom duty Rs. 20,000 and (b) Refund of income tax Rs. 10,000.
12. Cost of pollution control device Rs. 200,000 and Rs. 25,000 expenses for income tax appeal are not included in above statement.

Required:

(a) Net (Assessable) income from Business

(b) Tax liabilities [14+2]

FINAL EXAMINATION
2063

M.B.S. / II year / Management — Full Marks: 80
Tax Laws and Tax Planning (Acc. 613) — Time: 4 hours

Candidates are required to give their answers in their own words as far as practicable.
The figures in the margin indicate full marks.

Group –A

Attempt ALL the questions.

1. "Self assessment of tax is effective only in advanced countries." Explain. Also state some measures that help to make the self assessment system effective in Nepal. [3+3]
2. What do you understand by 'Payment of Income Tax by Installments? State the provisions of the Act relating to payment of tax by installment. [2+4]
3. Write short notes with example where necessary: (a) Income from natural resources; (b) Tax evasion. [3+3]
4. Explain the term 'Jeopardy Assessment' according to Income Tax Act 2058. Also state the conditions mentioned in the Act where Jeopardy Assessment could be applied. [2+4]

OR

A customer purchased a computer from a retailer at a total payment of Rs. 27,146. Both middlemen – wholesaler and retailer charged 10% profit on their respective cost price. The applicable VAT rate is 13%.

Required:

(a) Cost price of wholesaler
(b) Amount of VAT paid by the wholesaler
(c) VAT collected by the government at each level of sales [2+2+2]

5. Given below is the summarized statement of cash relating to a Music Director for the previous year.

Receipts	Amount	Payment	Amount
To Balance b/d	600,000	By Purchase of a car	1,200,000
To Receipts from music		By Car maintenance	
Directors	1,000,000	expenses	60,000
To Royalty from various		By Salary to personal	
Music shows	500,000	assistance	210,000

To interest credited by		By Donations to	
to his bank saving account		political parties	200,000
After deducting 6% tax	9,400	By Balance of cash c/d	440,000

Additional information:

1 Car was purchased on Falgoon of the previous year.

2 Car was used for his official as well as private purpose at 2:1 ratio.

Required:

(a) Net (assessable) income from profession

(b) Statement of total income [4+2]

6. The following information relates to depreciable assets of a company fall under Group D.

1. Balance at the beginning of previous year Rs. 1,800,000
2. Purchases during the year:
   i. On Magh for Rs. 600,000
   ii. On Jestha for Rs. 900,000
3. Disposed off during the year:
   i. Book value at opening date Rs. 400,000
   ii. Cash disposed value Rs. 300,000

Required:

(a) Current amount of depreciation to be charged

(b) Depreciation base of assets at closing [3+3]

7. Given below is the Receipts and Payments Account of Mr. Gopal for the previous year.

Receipts	**Amount**	**Payments**	**Amount**
To opening balance	400,000	By salary to assistants	250,000
To Payment received from		By collection cost	15,000
natural resource after TDS	175,000	By taxi charge	200
To Royalty from books		By rent	6,000
after TDS	85,000	By donation to tax exempt	
To interest credited by the		organization	50,000
Bank in Gopal's saving		By purchase of furniture	150,000
account	940	By balance of cash at	
To rent from house letout		closing	312,240
after TDS	85,000		
To interest on money len-			
ding activities	85,000		
	783,440		783,440

Additional information:

1 Collection cost relates to collect natural resource and royalty from books.

2 Taxi charge relates to collect interest from private money lending activities.
3 Rent was paid for a room used for official purpose in his own house.
4 Depreciation on furniture is to be charged.

Required:

(a) Net (assessable) income from investment.
(b) Statement of total taxable income [4+2]

8. A Ltd., Company intends to invest Rs. 2,000,000 on its expansion program. The company wants to raise capital by using the following alternative capital structures.

Alternatives	1	2	3
Equity capital	1,500,000	1,000,000	1,000,000
10% term loan	-	1,000,000	500,000
15% private loan	500,000	-	500,000
Total	2,000,000	2,000,000	2,000,000

The company's anticipated average rate of return on its capital employed before charging interest and depreciation is 35%. This company falls under special group.

Required:

Appropriate capital structure for investment. Give your decision from income tax point of view.

Group - B

9. Tax planning is a scheme whereby an assessee can manage its cash flow properly. Do you agree with this statement? Explain this statement in the light of timing of activities. [6+2+8]

10. (a) Write briefly the tax exemption and tax rebates given to industries set up in backward areas under Income Tax Act 2058.

(b) A Ltd. Company is considering to invest a capital outlay of Rs. 2,500,000 in an Iron and Steel Industry. The company has preferred either Pyuthan or Gaighat to install the factory.

The company has anticipated the following profit before tax, depreciation and transportation expenses:

Year	1	2	3	4	5
PBTD (Rs.)	800,000	700,000	900,000	1,000,000	700,000

Government has not put any restriction to locate industry anywhere; however Income Tax Act 2058 provided the following rebates and concessions for location at different places.

a. A 20% rebate on tax is given if located at under developed region (Gaighat).

b. A. 25% rebate pm tax is given of located at underdeveloped region (Pyuthan).

The company has promised the following direct employment through out the year.

The company needs 10,000 tons of ore to run the factory at 90% level. Assume, the company met this level over the years.

Further information:

If the factory is located at Gaighat:

1. 80% inputs are available locally, and rest 20% is supplied from neighboring districts.
2. Road will be the means of transport.
3. Average transportation cost per ton would be- for locally collection Rs. 5 and from surrounding districts Rs. 30.
4. Company could employ more than 600 direct labors from the third year only.

If the factory is located at Pyuthan:

1. 70% inputs are available locally, and rest 30% would be collected from surrounding districts.
2. Road will be the means of transport.
3. Average transportation cost per ton would be- for local supply Rs. 5 and for surrounding districts Rs. 25.
4. Company provided a direct employment of more than 600 people throughout the year only from the second year of establishment.

Required:

As a tax planner, which alternative is the best from the point of view of tax? This asset falls under Group D. Assume that the corporate tax rate is 20%. [8]

11. Given below is the Trading and Profit & Loss Account of a Ltd. Company for the previous year:

Trading and Profit & Loss Account

Particulars	Amount	Particulars	Amount
To opening stock	400,000	By sales	2,500,000
To purchases	1,000,000	By closing stock	550,000
To freight	50,000		
To wages	450,000		
To gross profits c/d	1,150,000		
	3,050,000		3,050,000
To staff salaries	300,000	By gross profit b/d	1,150,000
To advertisement	50,000	By commission earned	20,000
To general expenses	350,000	By rent from staff quarter	50,000
To reserve for bad debts	20,000	By bad debts recovered	30,000
To depreciation	20,000	By gain on sale of	
To R&D costs	350,000	business assets	100,000
To dividend	60,000		

To life insurance prem-			
ium of staff	50,000		
To R&I costs	20,000		
To license renewal fees	2,000		
To contribution to			
recognized provident			
fund	30,000		
To net profit	98,000		
	1,350,000		1,350,000

Additional information:

1 Opening stock and closing stock both were over valued by Rs. 50,000.

2 Purchases include Rs. 150,000 for installation of pollution control device in the factory.

3 Wages include Rs. 50,000 for expenses incurred on installation of the pollution control device.

4 General expenses include Rs. 100,000 paid donation to different TE organizations. However, evidence of Rs. 30,000 could not be produced.

5 Depreciation base value of Plant on opening date was Rs. 800,000. An asset (Plant) of Rs. 200,000 was purchased on the month of Falgoon and a plant having book value of Rs. 200,000 was disposed off for Rs. 300,000 during the year.

6 Depreciation and repairs charged in the above profit and loss account were related to this plant.

7 20% of bad debts recovered were not allowed previously.

Required:

(a) Net (assessable) income from business

(b) Statement of total income

(c) Tax payable by the company [12+2+2=16]

Appendix - III

SOME SUGGESTED THESIS TOPICS

1. Modeling of Tax Liabilities Using Tax Accounting
2. Income Tax Evasion: A Theoretical Analysis of Underground Economy
3. Analysis of Scale of Taxation Equity on different types of Taxpayer
4. Return on Investment and Income Tax Planning in Nepal
5. A Potentiality of Strategic Corporate Tax Planning in Nepal
6. The Compliance Cost of the Corporate Income Tax in Nepal.
7. Aggressive Tax Planning and Curtailing Law in Nepal
8. Lack of Curtailing Law and Aggressive Tax Planning in Nepal
9. A Study on Tax Law Implementation and Political Barrier in Nepal
10. Presumptive Taxation in Nepal: A Sympathy or Exploitation of Weaknesses
11. Tax Evasion and Avoidance: A Historical Analysis of Political Corruption in Nepal
12. The Equality - Efficiency Tradeoff in Nepal's Tax System
13. Three Essays on Taxation: Income, consumption and property.
14. Significance and Effectiveness of Voluntary Compliance in Nepal
15. A Comparative Study of Income Tax Act 1974 and 2002.
16. A Comparative Study on Fine and Penalty Provision of Different Tax Law of Nepal
17. Capital Gain Tax and Its Collection System in Nepal
18. Vitality of Cash and Accrual Basis of Tax Accounting
19. Tax Revenue and Compliance Cost in Nepal
20. Selection of Tax Structure for Fairness Taxation in Nepal
21. Impact and Effectiveness of e-Filling in Nepal
22. Value Added Tax and Multiple Rate: A Requirement of Nepal
23. The Negative Impact of Taxation on Economic Growth
24. Taxation, Saving and the Rate of Interest
25. The Elasticity of Taxable Income: Evidence and Implications
26. Administrative and Compliance Costs of Taxation
27. Tax Policy and Planning in Developing Countries
28. The Influence of Globalization on Taxes and Social Policy
29. Indirect Taxation in Developing Economies: A Case Study of Nepal
30. In Search of Revenue: The Democratic Government of Nepal
31. Democratic Choice & Taxation:A Theoretical & Empirical Analysis.
32. Taxation and Public Goods: A Welfare-Economic Critique of Tax Policy Analysis
33. Taxation and Democracy: Nepal, India and Bangladesh

Normal view MARC view ISBD view

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